Bank of Uganda

Monetary Policy Report

August 2021

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ACRONYMS AND ABBREVIATIONS

AEs	Advanced Economies
BoP	Balance of Payments
BoU	Bank of Uganda
CAD	Current Account deficit
CBR	Central Bank Rate
CRM	Credit Relief Measure
CIEA	Composite Index of Economic Activity
COVID-19	Corona Virus Disease 2019
CPI	Consumer Price Index
EAC	East African Community
ECF	Extended Credit Facility
EU	European Union
EFU	Energy, Fuel and Utilities
EMDEs	Emerging Market and Developing Economies
FID	Final Investment Decision
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IMF	International Monetary Fund
M-o-M	Month-on-Month
NEER	Nominal Effective Exchange Rate
NPLs	Non- Performing Loans
OPEC	Organization of Petroleum Exporting Countries
PPs	Percentage Points
PSC	Private Sector Credit
SOPs	Standard Operating Procedures
Q-o-Q	Quarter on Quarter
REER	Real Effective Exchange Rate
T-Bills	Treasury bills
T-Bonds	Treasury bonds
UK	United Kingdom
US	United States
US$	United States Dollar
URA	Uganda Revenue Authority
Y-o-Y	Year-on-Year

EXECUTIVE SUMMARY

1. Bank of Uganda (BOU) left unchanged the Central Bank Rate (CBR) at 6.5 percent in August 2021 and maintained the band on the CBR at +/-2 percentage points. The margin on the rediscount rate and bank rate were left unchanged at 3 and 4 percentage points on the CBR, respectively.

2. Yields on government treasury bill and bonds for all maturities continued to fall, in line with the reduction in the CBR. The banks' weighted average lending rate maintained a downward trajectory since February 2021 in line with the reduction in CBR. However, Private Sector Credit (PSC) growth moderated despite the accommodative environment, reflecting a combination of subdued demand for and supply of credit, increased risk aversion, relatively low level of economic activity and the government's high domestic financing needs.

3. The growth in PSC in the quarter was dominated by household (which takes up to 18 percent of total banks' loans), real estates (which takes up to 20.4 percent) and manufacturing (which takes up 11.9 percent).

4. Despite the fall in the industry Non-Performing Loans (NPLs) ratio, credit risks remain elevated, largely due to the expected expiry of the credit relief measures, the impact of the second lockdown measures on business activities, and the slow pace of economic recovery.

5. A gradual easing of the first lockdown measures in June 2020 coupled with the accommodative fiscal, monetary, and macro-prudential policy environment contributed to a modest economic growth in FY2020/21, with a growth of about 3.3 percent. The growth trajectory has; however, been interrupted by the slow business activity on account of the second lockdown measures in June and July 2021 amidst rising cases of infections. The domestic economy activity is expected to continue on a recovery path. Real GDP is expected to grow in the range of 3.5-4.0 percent in FY2021/22.

6. In the medium-term, the Standard Operating Procedures (SOPs) and other restrictive measures that remain in place will continue to weigh down on economic activity. Real GDP is projected to return to 6-7 percent in FY2024/25, indicating that activity will likely remain well below pre-pandemic path for an extended time. The outlook is, highly uncertain and is highly conditional on the availability of vaccines, the potential emergence of vaccine-resistant virus strains and a balance between containment measures and economic recovery.

7. Implementation of the FY2020/21 budget was hindered by revenue shortfalls. Tax revenue underperformed by Shs. 2,212.4bn on account of lower than target direct taxes, international trade taxes and indirect taxes. Fiscal deficit was estimated at 9.9 percent of GDP was above target largely due to a 23.1 percent increase in expenditure, especially recurrent expenditure. The deficit was largely financed by an increase in net domestic financing. In FY2021/22, fiscal consolidation is projected to commence reflected in the projected fiscal deficit as percentage of GDP to decline to 6.4 percent. However, with revenue expected to underperform due to the resurgence in COVID infections and the lockdown of the economy, additional expenditure pressures could emerge thus curtailing the extent of fiscal consolidation.

8. On the external sector, in FY2020/21, the external sector strengthened, recording an overall balance of payments surplus in the quarter to June 2021. However, the current account deficit is estimated to have increased to 10 percent of GDP, up from 7 percent of GDP in the FY2019/20. The current account was financed by the surplus in the financial account which expanded in the FY2020/21 relative to the FY2019/20, attributed to increased capital inflows in form of budget support loan disbursements, a reversal in portfolio investment inflows, which more than offset the contraction in direct investment inflows. The current account deficit is likely to deteriorate in the medium term, as import growth is anticipated to recover amid pickup in domestic demand for consumption and investment after relaxation of most of the restrictions imposed during the second lockdown. Import growth is likely to outpace the expected growth in exports growth on account of the recovery in external global demand. However, the financial account is likely to widen as foreign direct investment and related financial inflows are projected to rise in the medium-term as activities resume in the oil sector and, external loan disbursements increase in support of new and existing public sector projects.

9. The Uganda Shilling remained relatively stable against the dollar supported by a combination of domestic and global fundamentals, including large donor support inflows, high personal remittances and transfers from NGOs, relatively high portfolio inflows from offshore players targeting treasury securities, increased export earnings especially of coffee and fish, subdued private sector demand and global weakening of the US dollar. In the near term, the shilling is expected to remain relatively stable, in part, due to low domestic demand. However, in the medium-term, the exchange rate is expected to depreciate on account of a pick-up in both private sector and government demand for imports, possible slowdown in portfolio inflows and unwinding of coffee export receipts amidst strengthening US dollar.

10. Inflationary pressures remain benign largely reflecting the existence of spare capacity in the economy. Headline and core inflation averaged 2.4 percent and 3.4 percent, respectively, in 12 months to July 2021. Inflation is expected to remain relatively subdued around the 5 percent target in the medium-term. Inflation might rise gradually in the near-term due to temporary

effects of the COVID-19 containment measures but is forecast to remain below the 5 per cent target, as excess capacity continues to exert downward pressure. In the medium-term, as demand recovers, inflation is forecast to rise but stabilize around the 5 percent target.

1. GLOBAL DEVELOPMENTS

1.1 Global economic activity

The recovery in global economic growth is on course supported by wide vaccination and substantial policy support measures, particularly in advanced economies. The IMF World Economic Outlook update for July 2021 maintained growth in global GDP at 6 percent for 2021. The 2022 growth rate was revised upwards 0.5 percentage points (**Table 1**).

There are, however, noticeable divergences in growth prospects across regions and countries largely reflecting variations in vaccinations and extent of policy support. For advanced economies, growth is expected to rebound strongly in 2021 than previously forecast driven by wide vaccination coverage and significant policy support measures. In contrast, for emerging market and developing economies, growth is expected to be subdued in 2021 due to an expected resurgence in infections amidst fiscal buffers. For Sub-Saharan Africa (SSA), growth will remain positive, but among the world's lowest in 2021, reflecting slow vaccination and limited policy support measures.

Table 1: Global economic growth

		July 2021 projections		Deviation of July 2021 from April 2021 projections	
	2020	2021	2022	2021	2022
World Output	**–3.2**	**6.0**	**4.9**	**0.0**	**0.5**
Advanced Economies	**–4.6**	**5.6**	**4.4**	**0.5**	**0.8**
United States	–3.5	7.0	4.9	0.6	1.4
Euro Area	–6.5	4.6	4.3	0.2	0.5
Japan	–4.7	2.8	3.0	–0.5	0.5
United Kingdom	–9.8	7.0	4.8	1.7	–0.3
Emerging Market & Developing Economies	**–2.1**	**6.3**	**5.2**	**–0.4**	**0.2**
China	2.3	8.1	5.7	–0.3	0.1
India	–7.3	9.5	8.5	–3.0	1.6
Russia	–3.0	4.4	3.1	0.6	–0.7
Brazil	–4.1	5.3	1.9	1.6	–0.7
Sub-Saharan Africa	**–1.8**	**3.4**	**4.1**	**0.0**	**0.1**
South Africa	–7.0	4.0	2.2	0.9	0.2

Source: World Economic Outlook, July 2021 Update

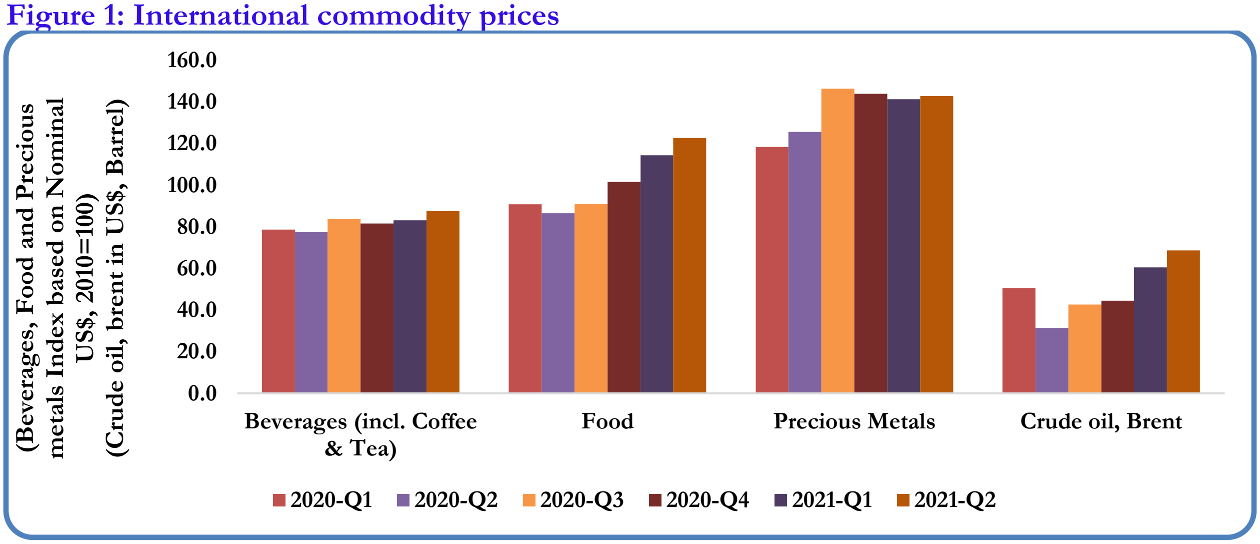
The recovery in the global economic activity is expected to continue supported by wide vaccination coverage and ongoing policy measures. The outlook is, however, more uncertain and is highly subject to the evolution of the virus. Moreover, more persistent inflationary pressures, particularly in advanced economies may prompt some central banks to raise policy rates earlier than expected, leading to tighter financial conditions, especially for emerging market and developing economies amidst limited fiscal buffers. In addition, pre-pandemic risks factors such as the geopolitical tensions continue to be relevant. Tensions between vital global players remain elevated on numerous fronts, including trade, intellectual property and cybersecurity.

1.2 International commodity prices

There was a noticeable recovery in all commodity prices reflecting strong global demand. The crude oil prices are returning to their pre-pandemic levels largely supported by the rebound in global demand and declining inventories (**Figure 1**). The brent crude oil prices surged upward in July 2021, reaching US dollar 74.4 per barrel, an increase of 1.8 percent from June 2021.

Increases in the international commodity prices are expected to continue in 2022 largely driven by temporary mismatches in supply and demand and adverse weather conditions. Brent crude oil prices are; however, expected to remain near current levels for the remainder of 2021, but moderate to US dollar 62 per barrel in 2022 as the Organization of the Petroleum Exporting Countries (OPEC) and partners or OPEC+ are expected to gradually increase production.

Figure 1: International commodity prices



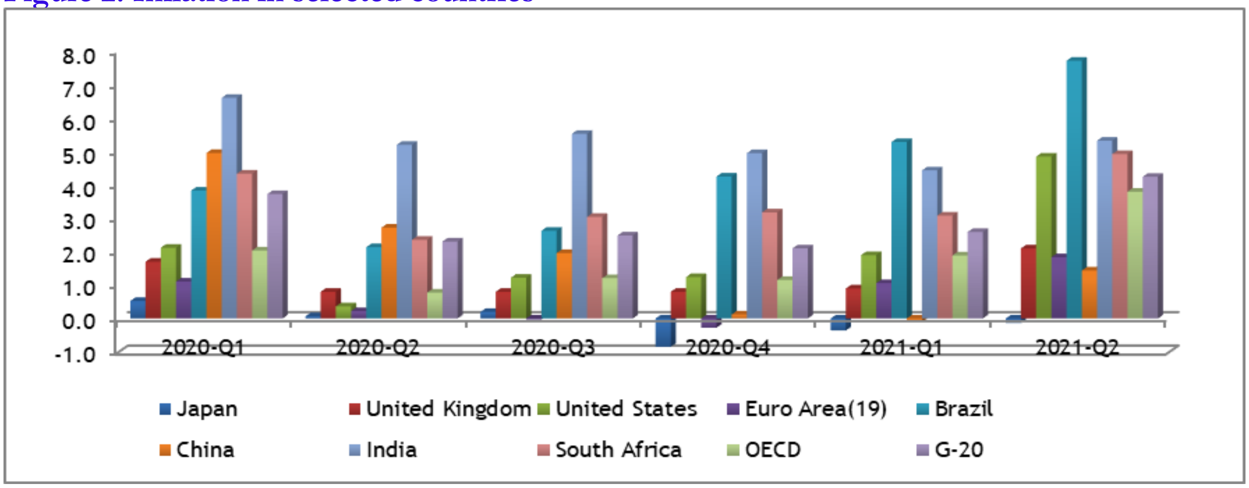
Source: World Bank

1.3 Global inflation

Inflation picked up in both advanced economies and emerging markets and developing economies driven by the recovery in global growth and short-term supply-side bottlenecks. In advanced economies, inflation averaged 2.2 percent in June 2021, up from 1.7 percent in April 2021, and among emerging markets and developing economies, inflation averaged of 4.9 percent, up from 4.6 percent in April 2021 (**Figure 2**).

Inflationary pressures are; however, expected to subside in the latter part of 2021 as transient factors abate. Nevertheless, in some emerging market and developing economies, inflation may remain elevated in 2022 driven largely by the continued food price pressures and the lagged impact of higher global oil prices.

Figure 2: Inflation in selected countries



Source: OECD Statistics

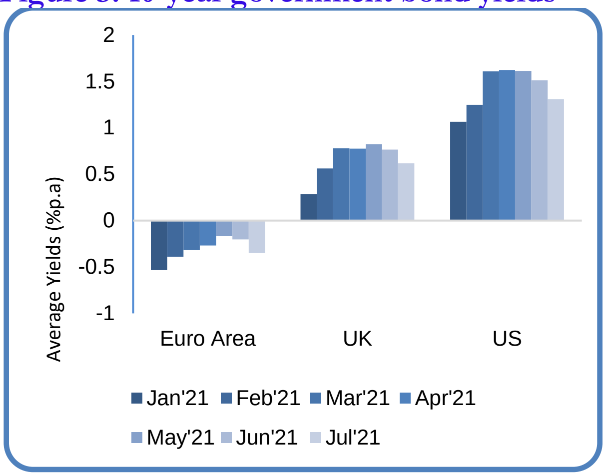
1.4 Global financial markets

The global financial conditions remain very accommodative despite uncertainties related to the spread of the delta variant and fears for higher inflation. The US 10-year nominal rates have fallen since May (**Figure 3**) likely reflecting concerns that the spread of the delta variant will weigh on economic activity longer than expected. However, volatility in interest rates has increased, reflecting heightened uncertainty about the inflation outlook and the associated concerns that key central banks may commence policy tightening earlier than expected.

The US dollar has continued to strengthen (**Figure 4**) driven largely by a safe-haven bid on fears that a surge in the spread of the delta variant could derail the global recovery. In contrast, most emerging market and developing economies' currencies have depreciated against the US dollar, especially for economies with large exposures to portfolio capital flows.

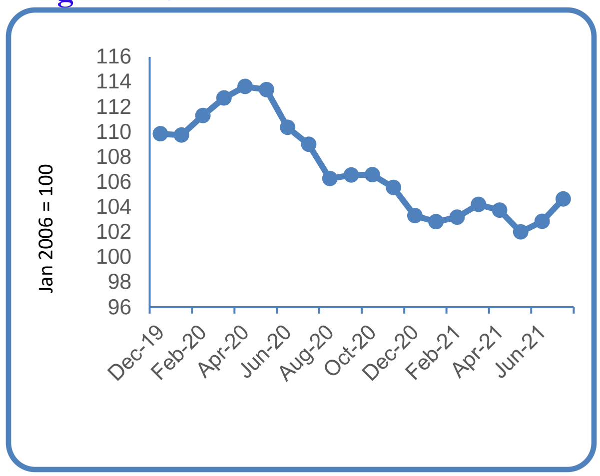
In the medium term, a possible tightening of monetary policy in advanced economies, if the current inflationary pressures become persistent and broad-based, will lead to tightening financial conditions for emerging markets and developing economies.

Figure 3: 10-year government bond yields



Source: OECD

Figure 4: US dollar index



Source: US Federal Reserve

2. DOMESTIC DEVELOPMENT AND OUTLOOK

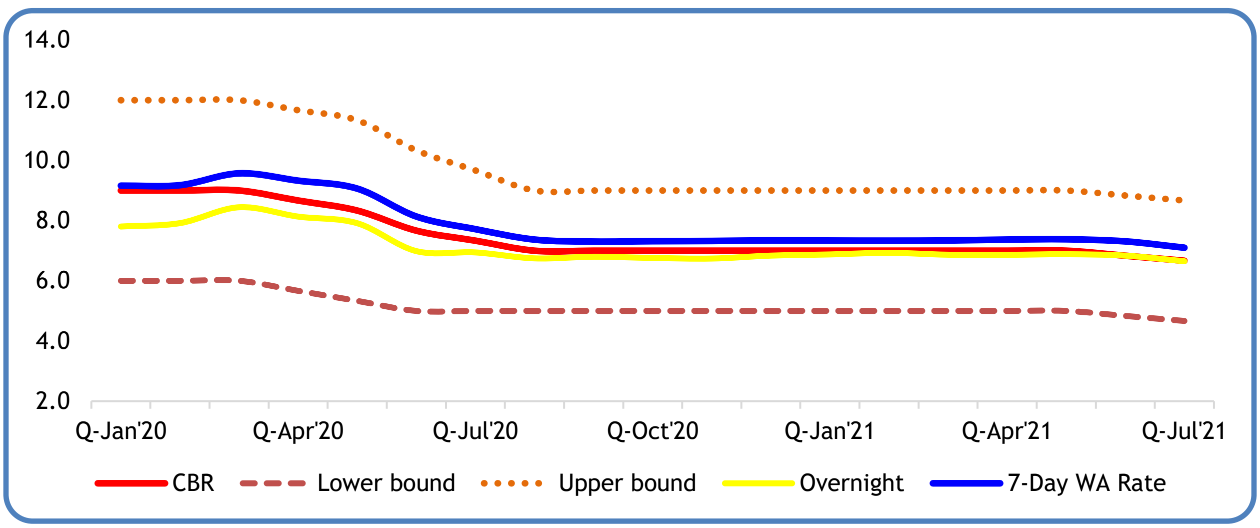
2.1 Domestic financial markets

A developed financial market can efficiently channel liquidity from institutions with surplus funds to those in deficits, provides effective price-discovery mechanism and help transmits monetary policy to the real economic activity and prices. A comprehensive assessment of the financial market is therefore vital for judging assessing the central bank's actions and consequences of its actions.

2.1.1 Interbank money market

Bank of Uganda (BOU) continued to implement monetary policy decisions through market-based financial instruments, in the process of aligning the interbank money markets with the monetary policy stance. The domestic interbank money market therefore remained relatively stable in the quarter to July 2021. As shown in **Figure 5**, all the interbank interest rates were well anchored around the Central Bank Rate (CBR), with the 7-day interbank rate, the operational target averaging 7.1 percent down from 7.4 percent in the quarter to April 2021 and the overnight interbank rate declining to 6.7 percent from 6.9 percent in line with the reduction of the CBR in June 2021.

Figure 5: Interbank interest rates and Central Bank Rate



Source: Bank of Uganda

2.1.2 Primary market for treasury securities

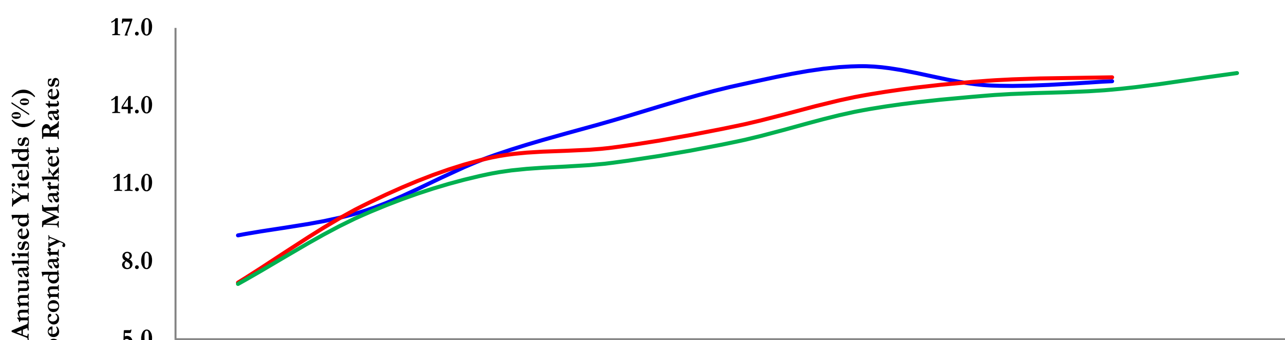
In the primary market, treasury bill and bond yields for all maturities continued to fall, in line with the reduction in the CBR. Yields on the 91-day, 182-day and 364-day bills fell to 7.2 percent, 9.5 percent and 10.5 percent, respectively in the quarter to July 2021 from 7.4 percent, 10.5 percent and 11.9 percent in the quarter.

Yields on the 2-year, 3-year, 5-year, 10-year and 15-year bonds declined to 11.5 percent, 12.8 percent, 13.4 percent, 13.74 percent and 14.4 percent in the quarter to July 2021. The treasury new 20-year bond sold for 16.0 percent in the quarter to July 2021.

2.1.3 Secondary Market for Treasury Securities

The yield curve in the secondary market continued to fall in line with the decline in yields in the primary market. The average annualised 91-day 182-day and 364-day Treasury bill yields fell to 7.1 percent, 9.8 percent and 11.4 percent, respectively in the quarter to July 2021, respectively, relative to the previous quarter (**Figure 6**). The 2-year, 3-year, 5-year, 10-year and 15-year bond annualised yields fell to averages of 11.8 percent, 12.6 percent, 13.8 percent, 14.4 percent and 14.6 percent, respectively in the quarter to July 2021, while the new 20-year bond traded at 15.3 percent.

Figure 6: Yields on the bills and bonds



	91-days	182-days	364-days	2-years	3-years	5-years	10-years	15-years	20-years
Q-Jul'20	9.0	9.9	12.0	13.4	14.8	15.5	14.8	14.9	
Q-Jun'21	7.2	10.1	12.0	12.4	13.2	14.4	15.0	15.1	
Q-Jul'21	7.1	9.8	11.4	11.8	12.6	13.8	14.4	14.6	15.3

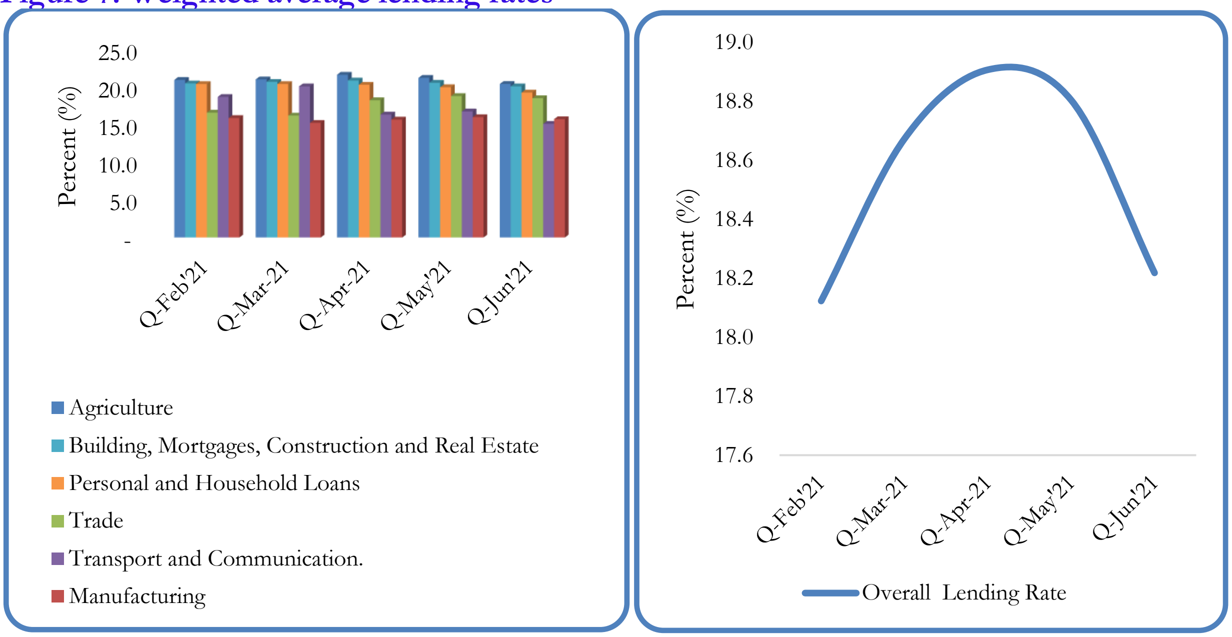
Source: Bank of Uganda

2.1.4 Lending and deposit interest rates

The banks' weighted average lending rate has maintained a downward trajectory since February 2021 in line with the reduction in CBR. The average lending rate stands at 17.0 percent in June 2021 from 19.6 percent in May 2021 (**Figure 7**). Lending rates on shillings loans reduced to a quarterly average of 18.2 percent in June 2021 from 18.9 percent in April 2021. However, lending rates on foreign currency denominated loans increased to 6.4 percent from 5.9 percent.

All the sectors except transport and communication witnessed declines in lending rates in June 2021 relative to May 2021, but there are noticeable divergences on a quarterly basis.

Figure 7: Weighted average lending rates



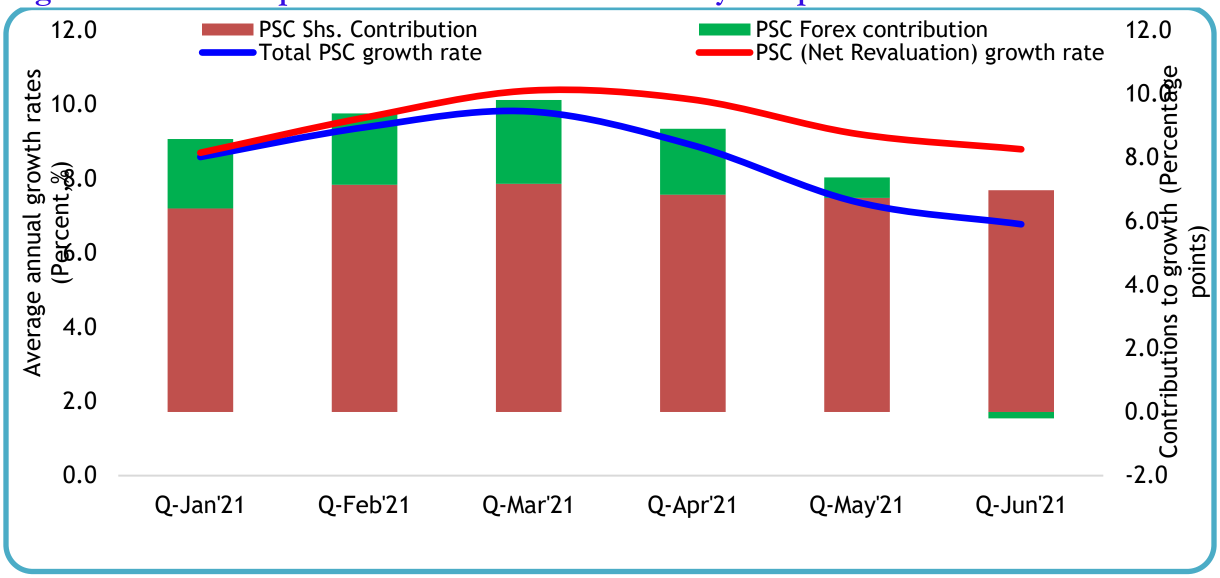
Source: Bank of Uganda

2.1.5 Credit to the private sector

Private Sector Credit (PSC) growth moderated despite the accommodative environment, reflecting a combination of subdued demand for and supply of credit, largely attributable to heightened uncertainty related to the Covid-19 pandemic, increased risk aversion, relatively low level of economic activity and government's high domestic financing needs. On a quarterly basis, annual PSC growth fell to an average of 6.8 percent in the quarter to June 2021 from 9.8 percent in the quarter to March 2021, with May 2021 registering the lowest growth rate of 5.4 percent (**Figure 8)**. PSC, including loans disbursed by the Uganda Development Bank (UDB) grew by 8.8 percent in the quarter to June 2021 from 12.9 percent in the quarter to March 2021.

PSC is expected to grow at a moderate pace in the near-term largely due to heightened uncertainty related to Covid-19 pandemic and the slow pace of economic recovery. In the medium- to long-term, however, PSC growth is expected to be stronger largely due to improved health metrics on account of wide vaccination outreach, which should pave way for a full reopening of the economy.

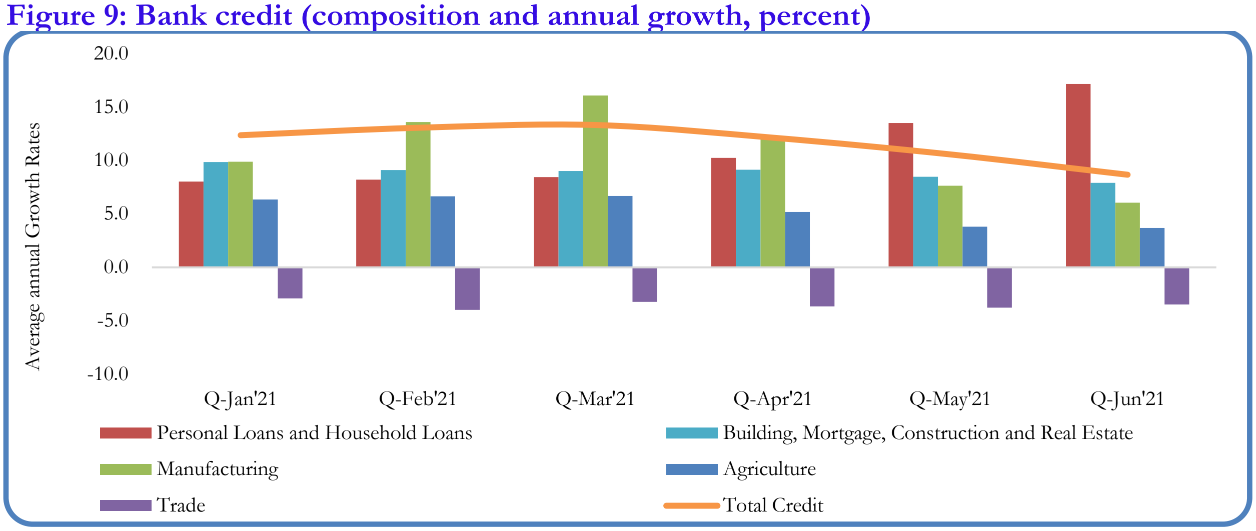
Figure 8: Growth in private sector credit and currency composition



Source: Bank of Uganda

Growth in PSC in the quarter to June 2021 was dominated by household (which takes up to 18 percent of total banks' loans), real estates (which takes up to 20.4 percent) and manufacturing (which takes up 11.9 percent) sub-sectors (**Figure 9**). However, growth in PSC in the trade sub-sector, which is one of the dominant contributors to PSC, with approximately 18 percent, and business services remained subdued, declining to *minus* 3.5 percent and *minus* 3.6 percent, respectively in the quarter to June 2021 relative to *minus* 3.8 percent and *minus* 3.1 percent in the previous quarter.

Figure 9: Bank credit (composition and annual growth, percent)

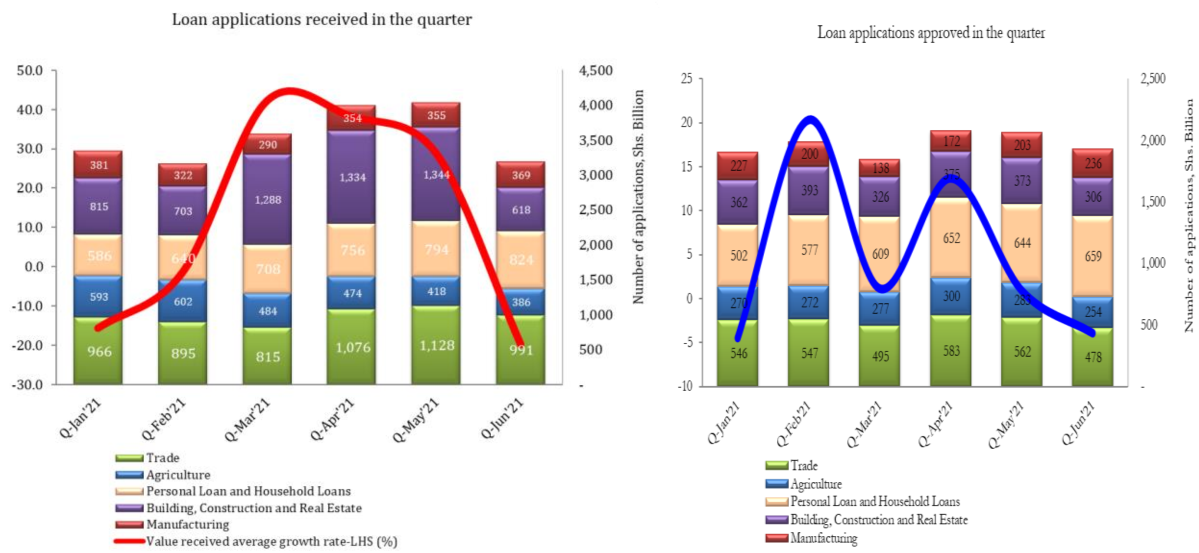


Source: Bank of Uganda

2.1.6 Demand and Supply of Credit

The value of loan approvals, which is a proxy for supply of credit increased in the quarter to June 2021, rising to Shs.2.3 trillion, up from Shs.2.2 trillion in the previous quarter. However, the value of loan, which is a proxy for the demand for credit decreased by 24.4 percent to Shs.3.8 trillion from Shs.5.0 trillion in quarter to March 2021, reflecting the slow pace of the recovery in economic activity (**Figure 10**).

Figure 10: Growth in application and approval of loans (percent)



Source: Bank of Uganda

2.1.7 Asset quality

Commercial banks' asset quality improved, largely on account the impact of the ongoing credit relief measures (CRMs). On aggregate, the share of Non-Performing Loans (NPLs) to total gross loans reduced to 4.8 percent in June 2021 from 5.4 percent in March 2021. However, there are mixed performances at the sectoral level (**Table 2**).

Despite the fall in NPLs, credit risks remain elevated going forward, largely due to the expected expiry of the CRMs, the impact of the second lockdown measures on business activities, and the slow pace of economic recovery.

Table 2: Non Performing Loans by sector

SECTOR	Dec-21	Mar-21	Jun-21	Sep-21	Dec-21	Mar-21	Jun-21
AGRICULTURE	8.8	9.8	9.4	8.5	8.2	7.3	4.2
MINING & QUARRYING	0.3	0.1	5.6	5.7	7.3	7.6	7.8
MANUFACTURING	2.4	2.4	2.2	2.2	2.1	2.6	2.1
TRADE & COMMERCE	7.5	7.4	8.9	7.6	8.7	8.0	6.7
TRANSPORT & COMMUNICATION	2.9	2.1	2.1	2.1	1.2	3.0	2.2
BUILDING, CONSTRUCTION & REAL ESTATE	4.5	4.4	6.5	4.7	4.9	5.7	6.2
ELECTRICITY & WATER	0.1	30.9	21.6	18.0	18.2	17.1	17.5
BUSINESS SERVICES	2.7	2.9	3.5	3.1	3.5	5.2	4.0
COMMUNITY, SOCIAL AND OTHER SERVICES	5.4	2.2	2.1	1.2	1.3	1.3	2.3
PERSONAL AND HOUSEHOLD LOANS	2.8	4.0	5.0	4.6	4.8	4.4	4.3
OTHER ACTIVITIES	5.0	6.9	6.7	6.6	7.5	8.9	8.1
STAFF LOANS							
OVERALL NPL RATIO	**4.9**	**5.4**	**6.0**	**5.2**	**5.3**	**5.4**	**4.8**

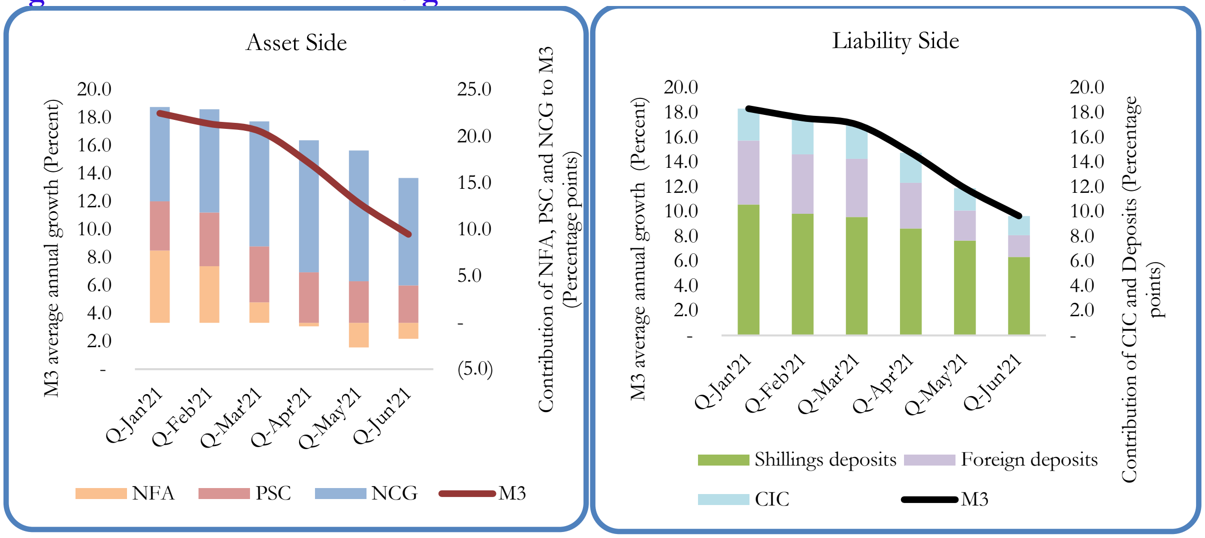
Source: Bank of Uganda

2.1.8 Money supply

Growth in monetary aggregates slowed down in the quarter to June 2021 reflecting the slow pace of economic recovery. The average annual growth in M3 stood at 9.7 percent, down from 17.1 percent in the quarter to March 2021. Growth in M2 also decelerated largely on account of a fall in growth in deposit liabilities—both demand and time and saving deposits—as well as, currency in circulation. The average growth in demand deposits declined to 8.7 percent down from 14.3 percent, while the growth in time and savings deposits declined to 14.1 percent down from 20.2 percent. The growth in currency in circulation fell by an average of 9.8 percent from 16.7 percent. The average growth in foreign currency deposits declined to 6.0 percent down from 16.6 percent.

The contribution of Net Domestic Assets (NDA) to growth in M3 decreased in the three months to June 2021. NDA contributed 11.4 percentage points to M3 growth, lower than the 14.9 percentage points contribution registered in the quarter to March 2021. The contribution of Net Foreign Assets (NFA) to growth in M3 also fell to -1.7 percentage points compared to 2.2 percentage points contribution. The contributions of Net Claims on Government (NCG) and PSC similarly reduced in the quarter to June 2021 to 11.5 percent and 4.0 respectively down from 13.4 and 6.0 percentage points in the quarter to March 2021 (**Figure 11**).

Figure 11: Contributions to M3 growth



Source: Bank of Uganda

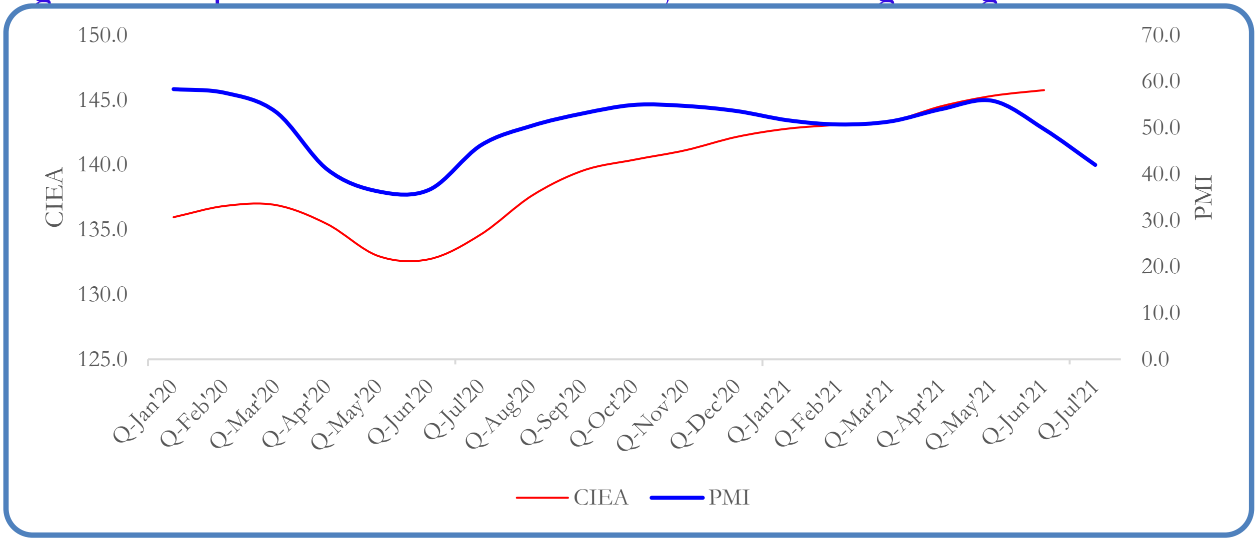
2.2 Domestic economic activity

Although monetary policy live under many guises, it ultimately boils down to adjusting the supply of money in the economy to achieve non-inflationary economic growth. It is generally agreed that in the long run, output is fixed and any changes in money supply only leads to increases in prices. Nonetheless, because prices and wages are sticky in the short run, changes in money supply affect investment and consumption of durable goods, which in turn affect aggregate demand and economic activity.

A gradual easing of the first lockdown measures in June 2020 coupled with the accommodative fiscal, monetary and macro-prudential policy environment contributed to a modest economic growth. Real GDP for FY2020/21 grew by 3.3 percent.

The growth trajectory has; however, been interrupted by slow business activity largely on account of the necessary second lockdown measures in June and July 2021 amidst rising cases of infections. Leading indicators of economic activity indicate a pickup in activity over the year, albeit slower than observed in recent months. The Composite Index of Economic Activity (CIEA) continued to grow upwards, on average by 1.7 percent in the three months to June 2021, from a growth of 0.8 percent in the three months to March 2021. On a monthly basis, CIEA grew by 0.2 percent in June 2021 relative to 0.6 percent in May 2021. The IHS Makit Purchasing Managers' Index, fell below the 50 percent mark in June 2021 to 34.9 and declined slightly further to 34.6 in July 2021, reflecting adverse effects of the lockdown measures announced in June 2021on business activity, as companies scaled back their employment and purchasing activity (**Figure 12**).

Figure 12: Composite Index of Economic Activity and Purchasing Managers Index



Source: CIEA-BoU and PMI-IHS Markit

2.3 Fiscal operations

Fiscal policy is an important stabilization tool. In the short-term, counter-cyclical fiscal expansion can help support aggregate demand and economic activity during downturns, while fiscal contraction can help cool down an economy that is growing at an unsustainable pace and could face risks of overheating. Therefore, coordination of fiscal and monetary policies plays a crucial role in the overall macroeconomic management and attainment of sustainable economic growth.

2.3.1 Expenditure and revenue

Fiscal operations during the FY2020/21 were constrained by revenue shortfalls and slow execution of externally funded government projects. Relative to the Uganda Revenue Authority (URA) target, tax revenue underperformed by Shs. 2,212 billion as a result of shortfalls in all tax heads except stamp duty (Table 3).

Direct domestic taxes, indirect domestic taxes and international trade taxes underperformed by Shs. 875 billion, Shs. 556 billion and Shs. 495 billion, respectively. Direct taxes underperformed largely due to shortfalls of Shs. 316 billion, Shs. 240 billion, Shs. 168 billion and Shs. 131 billion in Pay as You Earn (PAYE), Corporate tax, Rental Income tax and withholding tax, respectively. The Shortfall in PAYE was largely due to a slump in contributions from the financial sector as most banks laid off staff in favor of automation of most of the bank processes. Corporate tax and withholding tax underperformed largely due to lower profitability/income by firms triggered by challenges posed by the second lock down. The deficit in rental income tax collections is on account of the delay to implement the rental income tax collection solution by RippleNami.

The underperformance in domestic indirect tax and international trade taxes reflects lower domestic demand and import demand particularly in the second half of the year, which was partly caused by the second lockdown. International trade taxes underperformed largely on account of shortfalls in collections of import duty, infrastructure levy and VAT on imports of Shs. 172 billion, Shs. 152 billion and Shs.108 billion respectively.

On an annual basis, however, total net tax revenue registered a higher growth rate of 15.2 percent in the FY2020/21 compared to decline of 0.3 percent in the FY2019/20, reflecting a pick-up in economic activity in the first half of the FY2020/21, after the easing of the first lockdown measures. In contrast, the Non-Tax Revenue (NTR) declined by 8.2 percent in the FY2020/21 compared to the increase of 31.4 percent registered in the previous year largely due to a significant drop in non-URA NTR collections and Ministry of Works and Transport regulation fees.

Table 3: Revenue performance (July 2020 - June 2021, billion shilling.)

	Jul'18-Jun'19	Jul'19-Jun'20	Jul'20-Jun'21	URA Target Jul'20-Jun'21	Jun'21 Variation from Target	Annual change FY2019/20 (%)	Annual change FY 2020/21 (%)
Total Net Tax & Non-Tax Revenue	17,013.5	17,285.9	19,598.3	21,810.7	(2,212.4)	1.6	13.4
Net URA Tax Revenue (excluding refunds)	15,967.7	15,912.2	18,336.8	20,219.7	(1,882.9)	(0.3)	15.2
Gross Revenues	17,354.0	17,259.8	19,985.2	22,211.5	(2,226.3)	(0.5)	15.8
Direct Domestic Taxes	5,452.4	5,878.6	6,619.4	7,494.1	(874.7)	7.8	12.6
Indirect Domestic Taxes	3,890.5	3,874.7	4,472.9	5,028.6	(555.7)	(0.4)	15.4
o/w mobile money transfers	74.0	79.0	114.0	78.9	35.1	6.8	44.3
o/w Levy on mobile money	157.2	100.6	137.7	108.1	29.6	(36.0)	36.9
o/w Over the Top Tax (OTT)	49.5	59.7	59.1	64.4	(5.3)	20.6	(1.0)
Taxes on International Trade	6,865.0	6,446.6	7,505.9	8,001.3	(495.4)	(6.1)	16.4
Stamb Duty and Embrossing Fees	100.3	87.1	125.5	96.5	29.0	(13.2)	44.1
Non Tax Revenue	1,045.8	1,373.7	1,261.5	1,591.0	(329.5)	31.4	(8.2)
Tax Refunds	(340.5)	(374.8)	(386.9)	(400.9)	14.0	10.1	3.2

Source: Uganda Revenue Authority

Total government expenditure in the FY 2020/21 amounted to Shs. 34,947 billion largely supported by an increase in recurrent expenditure which exceeded programmed levels by Shs. 888 billion. However, development expenditure underperformed by Shs. 2,234 billion as a result of slow absorption (slow procurement process) by some government projects. Government continued with efforts to cushion its suppliers against the effects of the pandemic through clearance of domestic arrears which exceeded programmed levels by Shs. 391 billion.

On an annual basis, total government expenditure grew by 23.1 percent mainly due to scaled-up spending by the Government to counter the adverse economic effects of the pandemic as well as spending on the general elections. Similarly, expressed as a percentage of GDP, total expenditure increased to 23.0 percent in the FY2020/21 from 20.3 percent and 18.4 percent in FY2019/20 and the FY2018/19, respectively. The high expenditure, together with revenue shortfalls resulted in growth in the fiscal deficit (including grants) of 36.4 percent from Shs. 9,950 billion in FY2019/20. The deficit was financed, nearly in equal measure, by domestic and external financing. Domestic financing rose significantly largely due to an increase of 75.8 percent in net domestic financing to Shs. 6.82 trillion.

In FY2021/22, fiscal consolidation is projected to commence reflected in the projected fiscal deficit as percentage of GDP to decline to 6.4 percent. However, with revenue expected to underperform due to the resurgence in COVID infections and the lockdown of the economy, additional expenditure pressures could emerge thus curtailing the extent of fiscal consolidation.

2.3.2 Public debt stock

The provisional total public debt stock (at nominal value) as at end June 2021 stood at UGX. 70,383 billion, which is an increase of 22.5 percent relative to June 2020. Nominal debt/GDP stood at 46.3 percent, up from 41.0 percent and 35.3 percent by end June 2021 and June 2019, respectively. The increase in the stock of total public debt between June 2020 and June 2021 was mainly due to significant spending pressures to counter the adverse effects of the pandemic. A major risk to increased debt is the higher cost of financing. Debt service to domestic revenue ratio has been steadily rising to 24.6 percent in June 2021, up from 22.4 percent and 21.7 percent in June 2019 and June 2020, respectively.

However, an IMF-ECF loan of US$ 1 billion is expected to support post COVID-19 recovery and lend support to implementation of NDPIII. The external financing is likely to moderate further growth in public debt as the loan terms emphasize fiscal consolidation over the medium term as well as fiscal discipline. In addition, the IMF Board approved a new SDR allocation equivalent to US$650 billion to help individual countries build their reserve buffers, but with discretion over its utilization should needs arise. According to the ECF program, the SDR allocation is expected to primarily increase reserve cover to 4.5 months of imports, but in the event that budget financing does not materialize then the allocation can be used to meet the financing gap.

2.3.3 Fiscal operations in the FY2021/22

In the FY2021/22, a fiscal consolidation is planned with the fiscal deficit projected to decline to 6.4 percent of GDP. Revenue is expected to underperform by Shs. 1,836 billion due to the resurgence in COVID-19 infections and the lockdown of the economy. Government projects to spend Shs. 34,233 billion (**Table 4**), 6.4 percent lower than what was planned in the previous year with additional expenditure pressures funded through reallocations within the budget.

Table 4: Projected fiscal operations (billions shilling)

	Budget 2021/22	Q1	Q2	Q3	Q4	Projection 2021/22
Total revenue and grants	**23,850**	**4,728**	**5,957**	**5,732**	**5,598**	**22,014**
Revenue	22,425	4,366	5,427	5,384	5,414	20,590
Tax revenue	20,837	4,068	5,057	4,990	5,010	19,125
Grants	1,424	362	529	349	184	1,424
Expenditure and net lending	**34,233**	**8,522**	**8,298**	**7,691**	**7,721**	**32,233**
Recurrent expenditures	**18,961**	**4,129**	**4,841**	**4,958**	**4,769**	**18,697**
Interest payments	4,698	1,166	953	1,196	1,383	4,698
Development expenditures	**14,761**	**3,812**	**3,422**	**2,713**	**2,922**	**12,869**
External	6,758	1,657	2,196	1,299	1,605	6,758
Domestic	8,003	2,155	1,226	1,413	1,317	6,112
Net lending and investment	**111**	**27**	**34**	**21**	**30**	**112**
Other spending (including arrears)	400	555				555
Overall balance	**(10,383)**	**(3,795)**	**(2,341)**	**(1,959)**	**(2,123)**	**(10,218)**
Financing	**10,383**	**3,795**	**2,341**	**1,959**	**2,123**	**10,218**
External financing (net)	**7,240**	**838**	**2,134**	**2,505**	**1,598**	**7,076**
Disbursement	9,027	1,321	2,436	3,136	1,969	8,862
Amortisation (-)	(1,787)	(483)	(302)	(630)	(371)	1,787
Domestic financing (net)	**3,143**	**2,956**	**208**	**(546)**	**525**	**3,143**
Central Bank	**(8,347)**	**(263)**	**(2,013)**	**(3,051)**	**(3,020)**	**(8,347)**
o/w:advance and BoU repayments		1,235	(165)	(1,070)		-
o/w:petroleum fund withdrawal	200	200				200
o/w:domesic refinancing	(8,547)	(1,698)	(1,848)	(1,981)	(3,020)	(8,547)
Commercial banks	**10,015**	**2,459**	**2,034**	**2,242**	**3,282**	**10,016**
o/w:securities for fiscal purposes	1,468	760	186	261	262	1,469
o/w:securities for domestic amortisation	8,547	1,698	1,848	1,981	3,020	8,547
Non Bank	**1,474**	**760**	**187**	**263**	**263**	**1,474**

Source: Uganda Revenue Authority

2.4 Balance of payments and exchange rates

2.4.1 Balance of payments

A large current account (CA) deficit usually implies an external imbalance, which in a flexible exchange rate regime can be corrected by depreciation of the exchange rate. Persistent CA deficits may, however, require structural changes in the economy to enhance domestic productivity.

In FY2020/21, the external sector strengthened, recording an overall balance of payments surplus in the quarter to June 2021 of US$ 439 million. However, the current account deficit widened by 65 percent to a record high of US$ 4,139 million during the FY2020/21, equivalent to10 percent of GDP, up from 7 percent of GDP in the FY2019/20. The deterioration of the current account was largely attributed to a 62 per cent expansion in the services deficit. In addition, all sub accounts recorded deteriorations year on year.

The trade deficit widened, by 28 percent to US$ 3,083 million, as both exports and imports expanded, with the growth in the import bill outweighing the rise in exports. The import bill increased by US$ 2,125 million, driven by a 34 per cent increase in private sector imports, attributed to the increase in both private sector imports for investment and consumption by US$ 1,709 million and US$ 311 million, respectively. Exports expanded, posting a 38 per cent growth to US$ 5,259 million, largely due to higher export earnings for; coffee, beans, tea, cocoa beans, flowers, cement, sugar and gold. Amidst the pandemic-induced global financial uncertainty, foreign investors embraced gold as a safe asset, reinforced by the increase in its' international price during the year.

The services deficit deteriorated by 60 percent during the FY2020/21 due to lower export receipts amid increased transport payments. The tourism industry was severely affected by the pandemic; even after travel restrictions were relaxed in the third and fourth quarters of the FY2020/21, recovery in the tourism sector remained sluggish, with the effects persisting up to the end of the year.

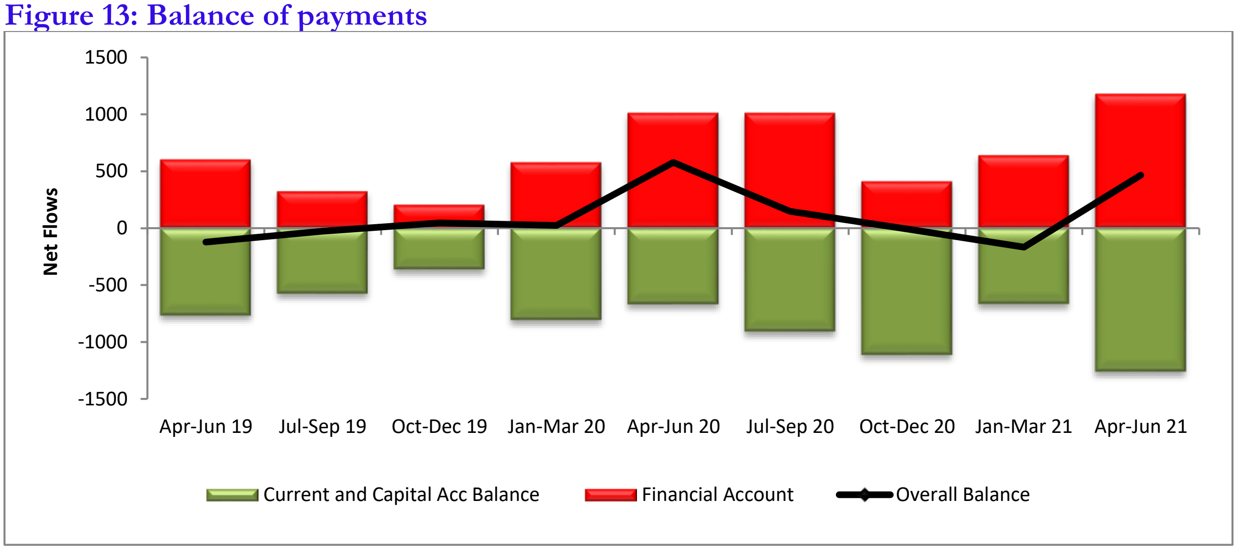
The primary income deficit worsened by US$ 81 million to US$ 706 million, driven by a 47 per cent increase in interest payments on public debt. Although persistent, remittance inflows are still below pre-pandemic levels on account of a fall in incomes of migrant workers due to loss of employment and wages during the pandemic-induced recession in host countries.

The current account was financed by the surplus in the financial account which expanded by 53 per cent to US$ 3,244 million in the FY2020/21, relative to the FY2019/20. The high inflows were largely attributed to increased capital inflows in form of budget support loan disbursements, coupled with a reversal in portfolio investment to net inflows of US$ 200 million from net outflows of US$ 40 million, which more than offset the contraction in direct investment inflows due to subdued investor sentiment and low activities in the oil sector. In addition, were reversals in domestic banks deposits abroad from a net deposit of US$ 300 million to net withdrawals of US$ 100 million. The stock of reserves increased to US$ 4,140 million, which is equivalent to 4.7 months of future imports of goods & services.

On a quarterly basis, the external sector improved in the quarter to June 2021, on the back of higher transfer surplus and increased capital inflows. However, the current account widened by 83 percent, primarily due to over 100 percent expansion in the trade deficit. Merchandise trade deficit deteriorated owing to a 32.1 percent increase in the import bill, which more than offset the 4.0 percent increase in export earnings. The services account deficit widened by 19.2 percent, largely due to a US$ 117.0 million increase in payments to non-residents for freight transportation services, associated with the increased import bill recorded during the quarter. The primary income account deficit contracted by 8.2 percent, largely attributed to a US$ 40.5 million decrease in public debt service (interest payments). The transfer surplus widened attributed to higher personal transfers and NGO inflows.

The Financial account widened by 84 percent, largely attributed to an increase in net capital inflows through the other investment, specifically budget support loan disbursements and net portfolio flows although, FDI inflows remained sluggish. Overall, a balance of payments surplus was recorded during the quarter to June 2021, leading to a US$ 465.2 million build up in reserve assets. The quarterly BOP developments are presented in **Figure 13**.

Figure 13: Balance of payments



Source: Bank of Uganda

The current account deficit is likely to deteriorate in the medium term, as import growth is anticipated to recover amid pickup in domestic demand for consumption and investment after relaxation of most of the restrictions imposed during the second lockdown. Import growth is likely to outpace the expected growth in exports growth on account of the recovery in external global demand. While the services deficit is likely to increase on account of expected recovery in travel receipts as the tourism sector gradually recovers, it is likely to be moderated by increased transport service payments in line with import growth. Income account deficit is expected to widen as economic recovery is expected to support improvement in the labour market conditions. Interest payments on external public debt is likely to contribute to the deficit.

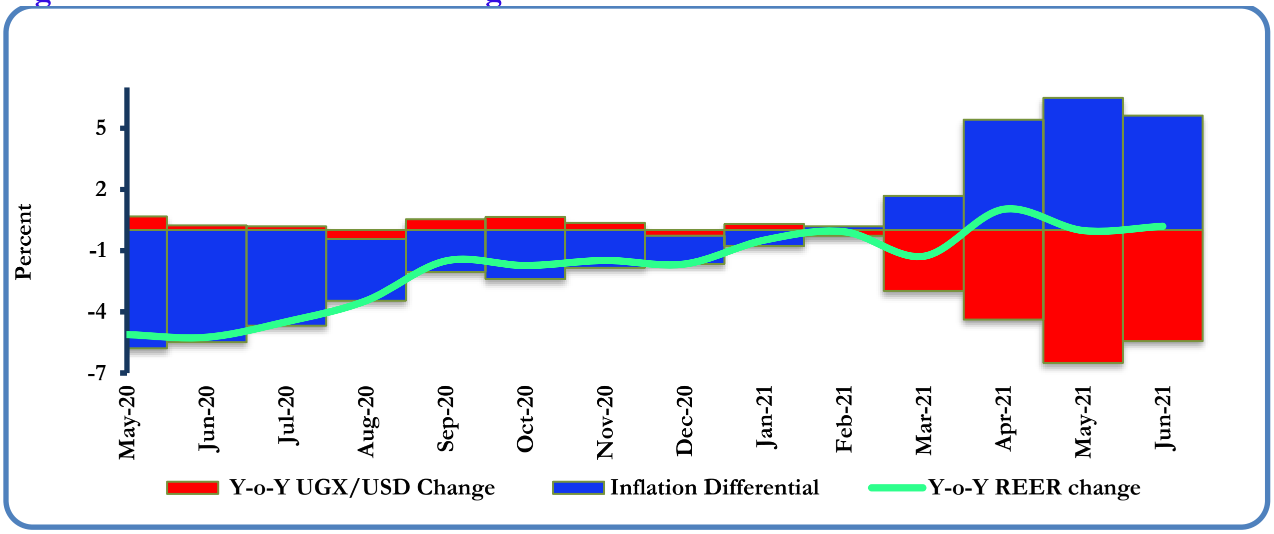
The financial account likely to widen as FDI and related financial inflows are likely to rise in the medium-term as activities resume in the oil sector and, capital inflows through other investment (loan disbursements) increase in support of new & existing public sector projects. However, a turnaround in portfolio investment to pre-pandemic trends is likely due to expected monetary policy normalization & potential increases in yields in AEs. Going forward, robust foreign exchange reserves will continue to support the external sector.

2.4.2 Exchange rates

The Uganda Shilling remained relatively stable against the dollar supported by a combination of domestic fundamentals and global economic environment, including, large donor support inflows, high personal remittances and transfers from NGOs, relatively high portfolio inflows from offshore players targeting treasury securities, increased export earnings especially coffee and fish, subdued private sector demands and global weakening of the US dollar. The shilling depreciated by 0.3 percent month-on-month, to a mid-rate of Ushs. 3,552.3 per US dollar in July 2021, relative to an appreciation 0.3 percent in June 2021.

On an annual basis, the shilling appreciated by 4.1 percent year-on-year, relative to an appreciation of 5.3 percent year-on-year. In May 2021, the shilling appreciated by 1.9 percent (m-o-m) and 6.3 percent (y-o-y). On a trade-weighted basis, the Nominal Effective Exchange Rate (NEER) appreciated by 0.6 percent (m-o-m) and 0.2 percent (y-o-y) in June 2021 on account of inflation differential. The exchange rate developments are presented in **Figure 14**.

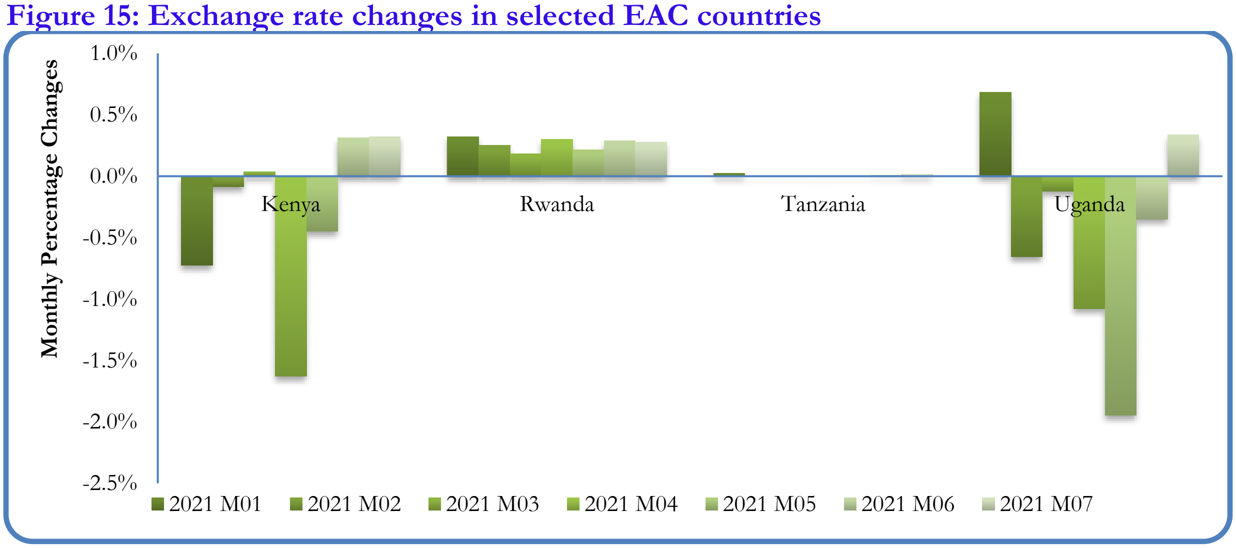
Figure 14: The real effective exchange rates



Source: Bank of Uganda

In July 2021, movements in the currencies of other East African Community (EAC) Partner States remained relatively stable against the US dollar albeit with depreciation bias in **Figure 15**. On average, the Tanzania Shilling remained relatively stable quarter-on-quarter at an average rate of TZS 2,298.6 per US dollar, while the Kenya Shilling and the Rwanda Franc depreciated by 1.2 percent and 5.4 percent respectively to average mid-rates of KES 107.7 and RWF 983.3 per US dollar. On annual basis, the Kenya Shilling, Rwanda Franc and Tanzania Shilling depreciated by 1.3 percent, 5.4 percent and 0.2 percent, respectively in June 2021.

Figure 15: Exchange rate changes in selected EAC countries



Source: Bank of Uganda

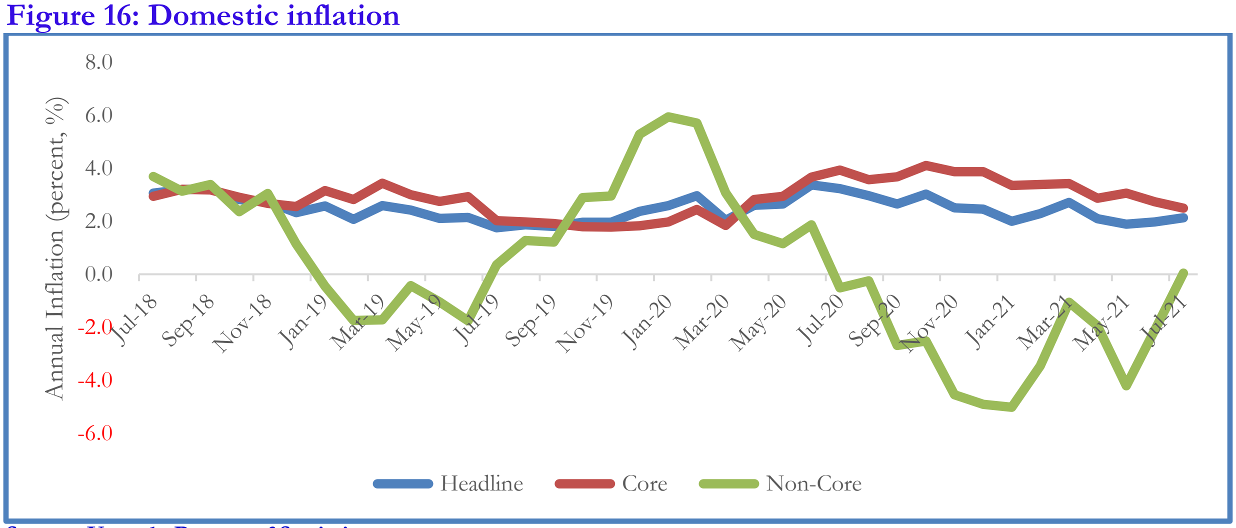
In the near term, the shilling is expected to remain relatively stable, in part, due to low domestic demand. However, in the medium-term, the exchange rate is expected to depreciate on account of a pick-up in both private sector and government demand for imports, possible slowdown in portfolio inflows and unwinding of coffee export receipts amidst strengthening US dollar.

2.5 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 extent of 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 appropriate monetary policy strategy, which in Uganda is formulated to deliver a medium-term core inflation target of 5 percent and to ensure that output is not only as close to potential as possible, but also consistent with the inflation objective.

Inflationary pressures remain benign largely reflecting the existence of spare capacity in the economy. Headline and core inflation averaged 2.4 percent and 3.4 percent, respectively, in 12 months to July 2021 **(Figure 16)**. However, on monthly basis, annual headline inflation rose slightly to 2.1 percent in Jul-21 from 2.0 percent in Jun-21, while annual core inflation declined to 2.5 percent from 2.7 percent. Food crops inflation increased to 0.9 percent in July 2021 from minus 2.8 percent registered in June 2021 while EFU inflation increased to minus 0.9 percent from minus 1.3 percent in the same period. Services inflation, however, decreased to 4.0 percent in July 2021 from 5.3 percent in June 2021.

Figure 16: Domestic inflation



Source: Uganda Bureau of Statistics

2.6 Outlook and risks to the inflation outlook

Monetary policy affects the real economy and prices with a considerable lag. A critical assessment of the future trajectory of economic activity and inflation relative to their potential growth paths and targets is thus crucial to determine an appropriate forward-looking monetary policy strategy.

2.6.1 Economic activity

The prevailing COVID-19 restrictive measures continue to weigh on economic activity. Therefore, economic activity is expected to grow in the range of 3.5-4.0 percent in the FY2021/22; a downward revision relative to the June 2021 projection. Economic growth is projected to return to above 6-7 percent in FY2024/25, indicating that activity is expected to remain well below pre-pandemic path for an extended period. The drivers of growth include increased public investment projects; strong rebound in Foreign Direct Investment (FDI) and remittance inflows; strong rebound in private sector credit as the accommodative monetary policy takes hold; strong rebound in external demand as the global economic recovery takes hold; and the International Monetary Fund (IMF)-Emergency Credit Fund (ECF) policy anchoring.

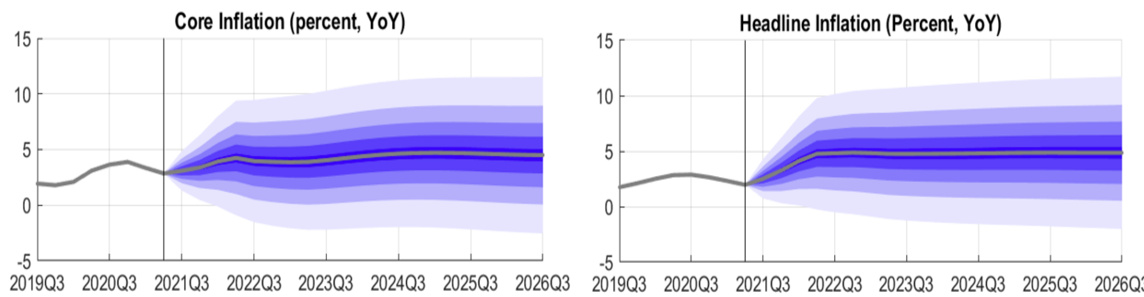
The outlook for Uganda's economy is however highly uncertain and is highly conditional on the availability of vaccines, the potential emergence of vaccine-resistant virus strains and a balance between containment measures and economic recovery. On the upside, economic growth could strengthen following increased rollout of vaccines allowing for all sectors of the economy to fully open amidst stronger domestic demand, improved credit supply, stronger global economic recovery, increased public investment, increased external financing and the finalization of the oil pipeline agreement which could drive stronger foreign and domestic private investment in the oil sector.

On the downside, any renewed surge in the corona virus cases, lingering effects of the recent lockdown and protracted lockdown in some contract-intensive service sectors, limited distribution of the COVID-19 vaccines leading to more resurgence of infections and mutations; subdued private sector credit growth; uncertain weather conditions and consequent adverse impact on agricultural production; may weigh down on the recent economic recovery. In addition, failure to conclude the IMF-ECF program reviews could dent investor confidence leading to reversals and sudden stops in portfolio flows with consequent volatility and tightening of financing conditions amidst limited domestic fiscal buffers.

2.6.2 Inflation and risks

Inflation is expected to remain relatively subdued around the 5 percent target in the medium-term. Inflation forecasts are projected lower in August 2021 relative to the June 2021 forecast round. Core inflation is forecast to be 0.1 percentage points and 0.2 percentage points lower in 2021 and 2022, while Headline inflation is forecast to be 0.6 percentage points and 0.4 percentage points lower in 2021 and 2022. Inflation might rise gently in the near-term due to temporary effects of the COVID-19 containment measures but is forecast to remain below the 5 per cent target, as excess capacity continues to exert downward pressure. In the medium-term, as demand recovers and the release of pent-up demand, inflation is forecast to rise but stabilise around the 5 percent target (**Figure 17**).

Figure 17: Inflation forecasts (baseline)



Source: Bank of Uganda

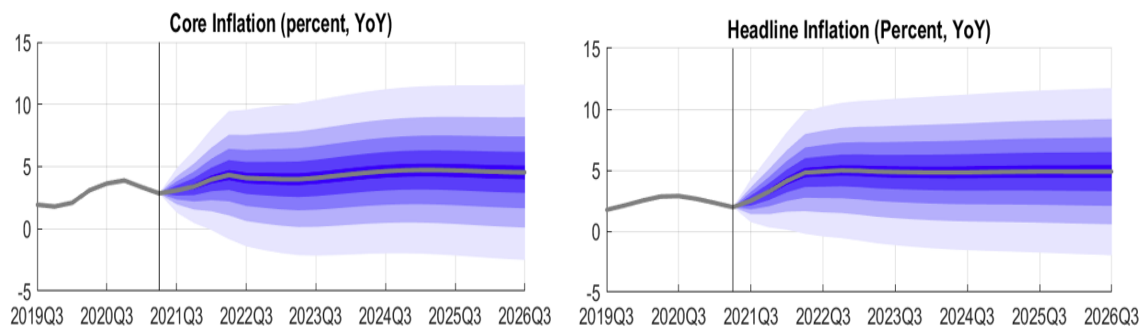
The forecasts in the baseline scenario are premised on several revisions of external and domestic assumptions of the previous forecast round. Regarding external assumptions, global growth is largely unchanged in 2021 but expected to be lower in 2022 as the impact of pandemic fiscal support fades away and monetary conditions become less accommodative. Effective inflation is largely unchanged in the near term but higher in the outer years due to intensifying demand pressures and high commodity prices as well as, base effects are expected to drive inflation up.

Oil prices are expected to increase to USD $65-70 per barrel over the forecast horizon due to expected removal of OPEC+ production limits. International food prices are expected to gradually increase going forward, reflecting a pickup in demand. Global interest rates increase in 2023Q1, one year earlier than previously assumed, based on the Fed's signal of the possibility to increase interest rates sooner than expected. On the domestic scene, a revised fiscal path that assumes fiscal consolidation over the forecast horizon and anticipated effects of the second lockdown on growth and inflation have been incorporated. In addition, the baseline forecasts assume no third wave of the pandemic.

The outlook for inflation is subject to both upside and downside risks, although assessment shows that the risks are balanced. A higher fiscal deficit, more depreciated exchange rate, higher international commodity prices and higher global growth could put upward pressure on domestic inflation. On the downside however, lower domestic growth that factors in a possibility of a third and fourth wave of the pandemic despite plans to vaccinate half the population by 2022 and persistent spare capacity could exert downward pressure on domestic inflation. Overall, the assessment indicates that the risks to the inflation outlook are balanced.

If the fiscal deficit is 2 percentage points higher in the FY 2021/22 and 1 percentage point higher in the outer years; headline and core inflation would average 0.2 percentage points higher than in the baseline scenario in the FY2022/23 (**Figure 18**).

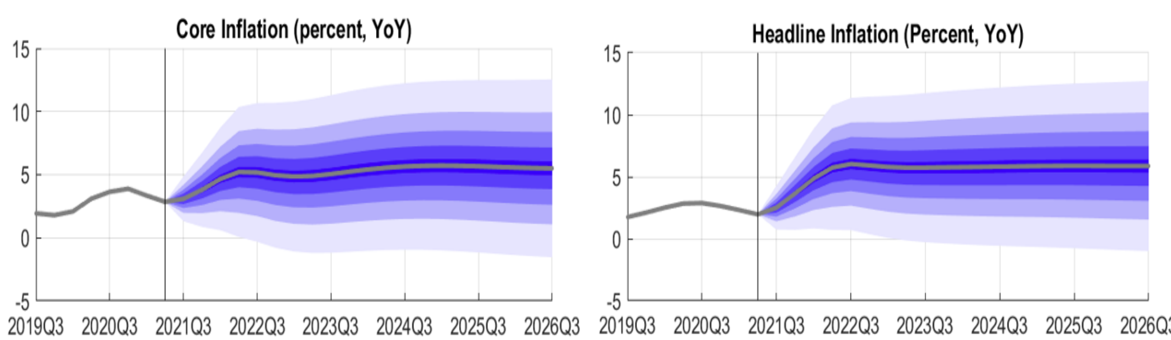
Figure 18: Inflation forecasts (scenario of a higher fiscal deficit)



Source: Bank of Uganda

If the exchange rate depreciates by 3 percent from 2021Q4 to the end of the forecast horizon; headline would average 0.2 and 1 percentage points higher than in the baseline scenario, during 2021 and 2022, respectively, while core inflation would average 0.1 and 1 percentage points higher than in the baseline scenario (**Figure 19**).

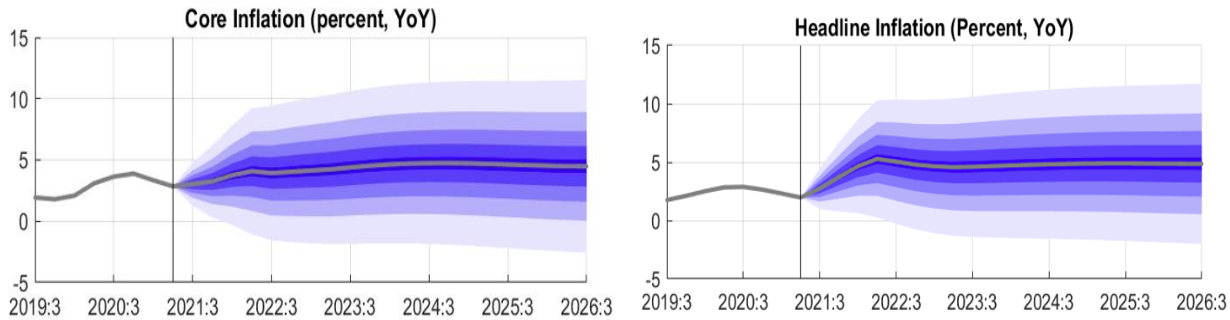
Figure 19: Inflation forecast (scenario of a more depreciated exchange rate)



Source: Bank of Uganda

In the event of higher global commodity prices; headline inflation would average, 0.2 and 0.3 percentage points higher than in the baseline scenario, during 2021 and 2022, respectively. Core inflation would remain relatively unchanged in 2021 and 2022 and average 0.3 percentage points higher in 2023 (**Figure 20**).

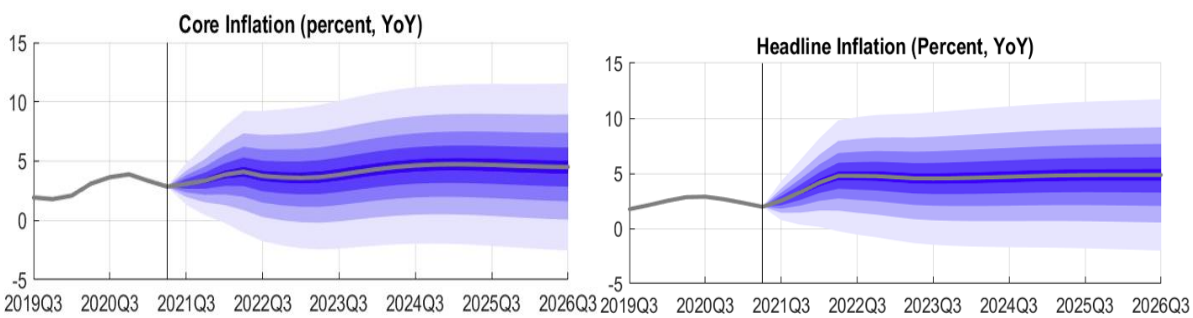
Figure 20: Inflation forecast (scenario of a higher global commodity prices)



Source: Bank of Uganda

If the economy suffers a third and fourth wave of the pandemic, economic growth will weaken and consequently, headline inflation would average 0.1 and 0.2 percentage points lower than in the baseline scenario in 2022 and 2023. Similarly, core inflation would average 0.2 percentage points lower than in the baseline in 2022 and 2023, respectively (**Figure 21**).

Figure 21: Inflation forecast (scenario of a weaker growth)



Bank of Uganda

3. CONCLUSION

The domestic economic growth momentum has been disrupted by a resurgence in the pandemic that necessitated restrictive measures. Indeed, leading indicators of economic activity indicate a slowdown in June-July 2021. The domestic economy activity is expected to continue on a recovery path. Economic activity is expected to growth in the range of 3.5-4.0 percent in FY2021/22. However, the growth projection is subject to the impact of the surge in infections and the containment measures on the economy.

In the medium-term, the Standard Operating Procedures (SOPs) and other restrictive measures that remain in place will continue to weigh down on economic activity. Economic growth is projected to return to above 6-7 percent in FY2024/25, indicating that the activity will likely remain well below pre-pandemic path for an extended time. The outlook is, highly uncertain and is highly conditional on the availability of vaccines, the potential emergence of vaccine-resistant virus strains and a balance between containment measures and economic recovery.

Inflationary pressures remain benign reflecting the existence of spare capacity. Headline and Core inflation stand at 2.1 percent and 2.5 percent in July 2021 respectively. The forecasts show that inflation will gradually return to the medium-term as demand picks up. Core inflation is expected to average 3.3 percent in 2021 and 4.3 percent in 2022, before returning to the medium-term target of 5 percent while headline inflation is projected to average 2.5 in 2021 and 4.8 percent in 2022.

Inflation could rise gently through the year due to the temporary effects of the Covid-19 containment measures but is forecast to remain below the 5 per cent target in the near-term, as excess capacity continues to exert downward pressure on activity.

In the medium-term, as demand recovers and the release of pent-up demand, inflation is forecast to rise but stabilize around the 5 per cent target. The outlook for inflation is, however, uncertain and is subject to both downside and upside risks. Nevertheless, we view these risks as broadly balanced.

It is against this backdrop, that the Bank of Uganda decided to maintain the Central Bank Rate (CBR) at 6.5 percent in August 2021 and maintain the band on the CBR at +/-2 percentage points on the CBR. The margin on the rediscount rate and bank rate were left unchanged at 3 and 4 percentage points on the CBR, respectively. Consequently, the rediscount rate and the bank rate remain 9.5 percent and 10.5 percent, respectively.