Bank of Uganda

Monetary Policy Report

October 2021

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ACRONYMS AND ABBREVIATIONS

AEs	Advanced Economies
BoP	Balance of Payments
BOU	Bank of Uganda
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
ECB	European Central Bank
ECF	Extended Credit Facility
EIU	Economic Intelligence Unit
EU	European Union
EFU	Energy, Fuel and Utilities
EMs	Emerging Market Economies
EMDEs	Emerging Market and Developing Economies
FID	Final Investment Decision
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IMF	International Monetary Fund
LICs	Low Income Countries
NEER	Nominal Effective Exchange Rate
NPLs	Non- Performing Loans
OPEC	Organization of Petroleum Exporting Countries
OPEC+	OPEC and partners
PSC	Private Sector Credit
SDR	Special Drawing Rights
SOPs	Standard Operating Procedures
SSA	Sub-Saharan Africa
REER	Real Effective Exchange Rate
UK	United Kingdom
US	United States
US	United States of America
US$	United States Dollar
URA	Uganda Revenue Authority
WTI	West Texas Intermediate
WEO	World Economic Outlook

EXECUTIVE SUMMARY

1. The Monetary Policy Committee (MPC), in its October 2021 meeting, assessed that inflation remains benign, that the risks to the economic growth outlook are skewed to the downside and that there remains considerable excess capacity in the economy. The MPC stressed that there is a persistence of high uncertainty and that economic and financial conditions are expected to remain volatile in the short to medium term. Against this backdrop, the MPC judged that keeping the CBR unchanged at 6.5 percent would be consistent with meeting the inflation target of 5 percent sustainably in the medium term. The band on the CBR is kept unchanged at +/-2 percentage points on the CBR and the margins on the rediscount rate and bank rate kept unchanged at 3 and 4 percentage points on the CBR, respectively. Consequently, the rediscount rate and the bank rate have been maintained at 9.5 percent and 10.5 percent, respectively.

2. Interbank money market rates remained well anchored around the CBR. Yields on government securities save for the 91-day Treasury bill have also moderated, reflecting the easing monetary policy stance. Commercial banks' interest rates declined in the quarter to September 2021 relative to the quarter to June 2021, largely reflecting the continued support of BOU's accommodative monetary policy stance. The weighted average lending rate on the shilling-denominated loans stood at 17.9 percent, lower than the average of 18.2 percent for the quarter to June 2021. However, relative to August 2021, lending rates rose partly reflecting risk aversion due to uncertainty associated with the adverse impact of pandemic-related restrictive measures and expiry of credit relief measures, as well as deterioration in asset quality.

3. Private Sector Credit (PSC) growth picked momentum in the quarter to September 2021, with year-on-year growth of PSC recovering to an average of 9.6 percent, up from 6.9 percent in the quarter to June 2021. This was partly supported by the easing of lockdown in July 2021 and accommodative monetary policy stance.

4. The effects of the pandemic related containment measures disrupted the recovery in economic activity with growth estimated to have declined in September 2021, although by less than the decline following the first lockdown in March 2020. Indeed, leading indicators of economic activity show that the economic recovery is on course, albeit at a slower pace than previously observed.

5. The annual growth in economic activity is projected to recover to 3.5-3.8 percent in the FY2021/22. Growth will depend on the release of pent-up demand, public investment in infrastructure, support to sectors that have been more adversely affected by the pandemic and the accommodative monetary conditions. A further increase in vaccination rates and easing of health-related restrictions should help the economy to bounce back strongly. Growth is projected at 5.5-6.0 percent in the FY2022/23 before increasing to 6.5-7.5 percent in the outer years. The outlook for Uganda's economy, however, remains contingent on the future path of the pandemic and is surrounded with significant uncertainty.

6. Fiscal operations for the first quarter the FY2021/22 were constrained by revenue shortfalls and slow absorption that is usually associated with the start of a new financial year. However, in a bid to support the recovery of economic activity, the Government expenditure for the first quarter of FY2021/22 was higher than budgeted. This necessitated front loading of Net Domestic Financing.

7. Uganda's Balance of Payment account recorded a surplus in the quarter to September 2021 that resulted into a US$276.4 million build up in international reserve assets, which is slightly higher than the surplus of US$ 207.6 million recorded in the quarter to June 2021. The surplus was largely supported by disbursement of Special Drawing Rights (SDR) allocation as well as increased foreign direct investments. The stock of reserves increased to US$ 4.4 billion, in the quarter to September 2021, which is equivalent to 4.5 months of future imports of goods & services.

8. The Uganda Shilling continued to strengthen against the US Dollar into the quarter to September 2021, although depreciation pressures emerged towards the end of the quarter. The strengthening of the shilling was driven by high remittance inflows and transfers from Non-Governmental Organizations (NGOs), strong portfolio inflows from offshore players looking for higher yields on treasury securities and increased export earnings particularly from coffee and tea exports. The depreciation in the last three days of September 2021 was on account of the strengthening of the US dollar against major international currencies, the recovery of domestic demand and bearish sentiments in anticipation of offshore demand which prompted banks to cover their short dollar positions.

9. Disinflation has persisted since October 2020, in part reflecting spare capacity in the economy. Headline and core inflation averaged 2.3 percent and 3.1 percent, respectively, in the 12 months to September 2021, which is below the BOU's medium-term target of 5 percent.

10. Inflation projections in the October 2021 forecast round are lower than in the August 2021 forecast round. The projection indicate that inflation will rise gradually in the near-term due to a combination of temporary effects of the COVID-19 containment measures, rise in international commodity prices and food crop prices, and supply chain disruptions, but remain below the 5 percent target in the medium-term as excess capacity continues to exert downward pressure on prices. In the medium-term, as demand recovers with the full reopening of the economy and the release of pent-up demand, inflation is forecast to rise but stabilise around the 5 percent target.

1. GLOBAL DEVELOPMENT AND OUTLOOK

1.1 Global economic activity

Global economic activity continues to recover albeit the momentum has weakened in the recent past in part due to resurgences of new variants of the covid-19 virus and persistent supply chain disruptions. Moreover, the recovery remains uneven across countries, sectors and demographic groups, largely reflecting variations in vaccinations and extent of policy support. In October 2021, the International Monetary Fund (IMF) revised global growth for 2021 down marginally by 0.1 percentage points to 5.9 percent compared to the July 2021 forecast (**Table 1**).

Table 1: Global economic growth

		October 2021 projection		Deviation from July 2021 projection	
	2020	**2021**	**2022**	**2021**	**2022**
World Output	**–3.1**	**5.9**	**4.9**	**-0.1**	**0.0**
Advanced Economies	**–4.5**	**5.2**	**4.5**	**-0.4**	**0.1**
United States	–3.4	6.0	5.2	-1.0	0.3
Euro Area	–6.3	5.0	4.3	0.4	0.0
Japan	–4.6	2.4	3.2	–0.4	0.2
United Kingdom	–9.8	6.8	5.0	-0.2	–0.2
Emerging Market & Developing Economies	**–2.1**	**6.4**	**5.1**	**0.1**	**-0.1**
China	2.3	8.0	5.6	–0.1	-0.1
India	–7.3	9.5	8.5	0.0	0.0
Russia	–3.0	4.7	2.9	0.3	–0.2
Brazil	–4.1	5.2	1.5	-0.1	–0.4
Sub-Saharan Africa	**–1.7**	**3.7**	**3.8**	**0.3**	**-0.3**
South Africa	–6.4	5.0	2.2	1.0	0.0

Source: World Economic Outlook, October 2021

Although global growth has now surpassed its pre-pandemic level, output and employment gaps persist in many countries especially in Emerging Market and Developing Economies (EMDEs). For Advanced Economies (AEs), growth is expected to moderate in 2021 than previously forecast due to a downward revision in growth prospects for the United States due to a fall in inventories and weak business investment as supply disruptions persisted in the second quarter and consumption softened further in the third quarter of 2021. In contrast, growth for EMDEs is expected to increase slightly in 2021, despite China's slight downgrade, as gains from commodity exporters are expected to offset the impact of the pandemic shocks. The outlook for low-income developing countries has been marred by worsening pandemic dynamics. Indeed, although Sub-Saharan Africa (SSA) growth is projected to remain positive, it's among the world's lowest in 2021, reflecting slow vaccination and limited policy support measures.

Overall, the recovery in global economic activity is expected to continue supported by wide vaccination coverage, ongoing policy measures and resolution of supply disruptions. There are however, risks to this outlook, which are largely assessed to be tilted to the downside mainly due to concerns of emergences of more aggressive virus strains amid sluggish vaccinations, supply shortages as resurgences of the new variants could cause shutdowns in some economies in Asia, and a production crisis that could arise from recent power shortages in China (see IMF World Economic Outlook, October 2021).

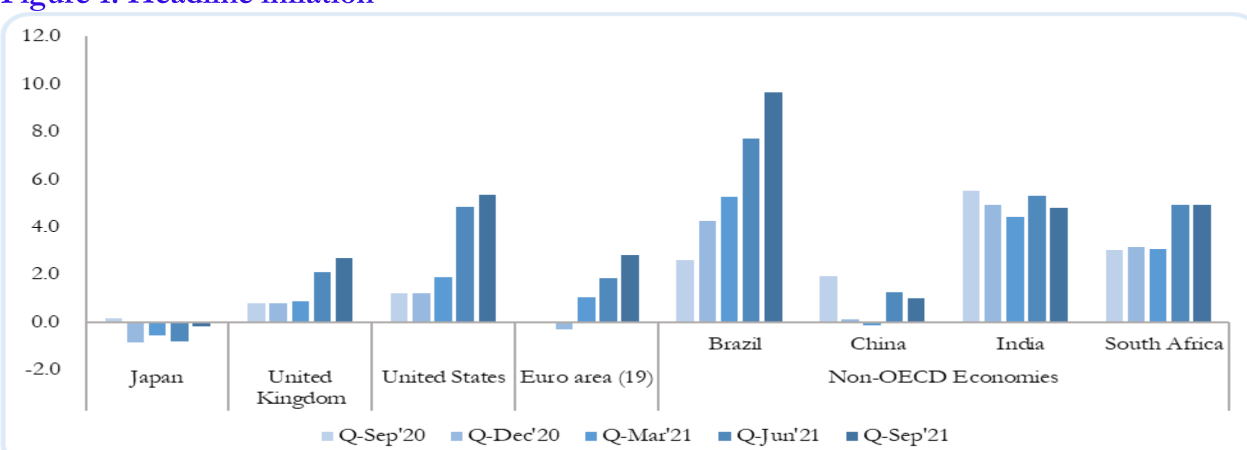
1.2 Inflation and commodity prices

1.2.1 Global inflation

Global inflation continued to rise in the quarter to September 2021 driven by rising commodity prices, firming demand and short-term supply-side bottlenecks. Headline inflation has been rising since January 2021 in AEs and Emerging Markets (EMs), although it has been relatively stable in Low-Income Countries (LICs). The trend in headline inflation for selected countries is as shown in **Figure 1.** A full reopening of most economies could cause private consumption to increase further. A combination of soaring demand and supply constraints may raise concerns for persistent high inflation.

Inflationary pressures are expected to peak in the latter part of 2021 but return to pre-pandemic levels by mid-2022 for AEs and EMDEs. The IMF projects that inflation will decline to an average of about 2 percent in AEs and 4 percent for the EMDEs by mid-2022. The risks to inflation are tilted to the upside over the medium term, including persistent supply chain disruptions and stronger than anticipated pickup in demand.

Figure 1: Headline inflation



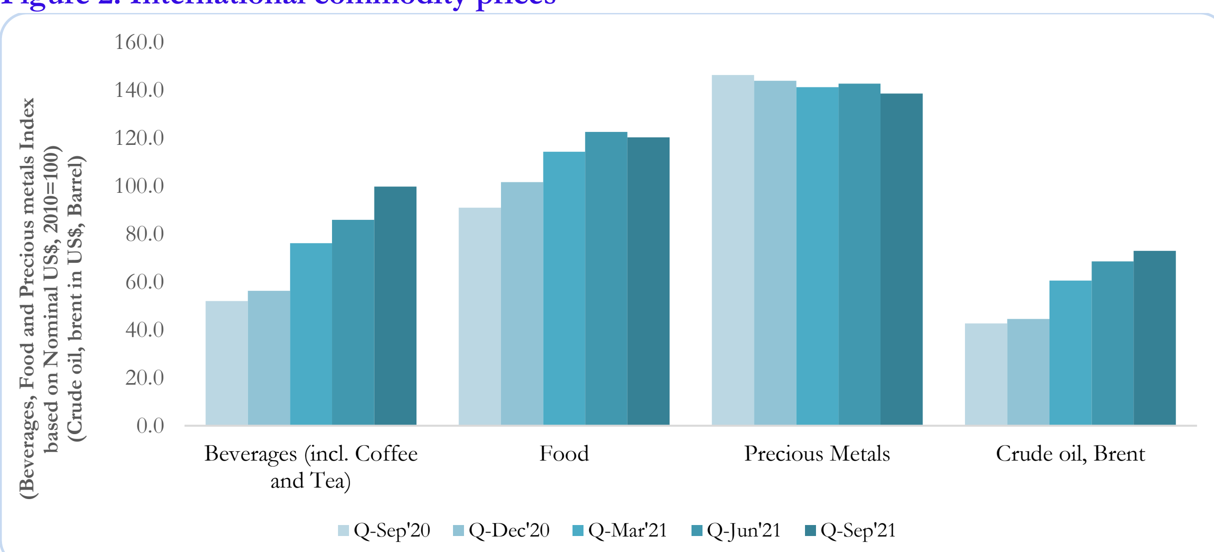
Source: OECD

1.2.2 International commodity prices

International commodity prices continued to rise, reflecting increased consumer demand, as economies recover amidst supply-side and weather disruptions. Global oil prices fluctuated within the quarter due to uncertainty regarding production levels of the Organization of Petroleum Exporting Countries (OPEC) and partners or OPEC-plus. Crude oil prices have returned to their pre-pandemic levels with brent prices surging upwards in September 2021 and hitting US$ 74.6 per barrel, an increase of 2.1 percent from June 2021. Brent crude oil prices averaged US$ 73.0 per barrel (**Figure 2)** in the quarter to September 2021, while and West Texas Intermediate (WTI) averaged US$ 70.6 per barrel. Non-energy prices, industrial raw materials and agricultural commodity price indices continue to recover on account of the recovery in global demand and re-emergence of supply chain disruptions. According to the IMF, sharp, broad-based increases in primary commodity prices, led by metals and energy commodities, between February and August 2021 were majorly driven by a strong recovery in commodity demand, loose financial conditions, and supply-side and weather disruptions.

Crude oil prices are projected to remain around US$ 70 per barrel in 2021 but gradually decelerate later due to an increase in production by OPEC-plus and possible entry of Iran into the global oil market. International food prices are expected to decline from this year's peak and gradually increase going forward, reflecting a pickup in demand. Overall, the risks to the oil prices are balanced with lower production capacity and the resurgence of COVID-19 posing major upside risks while higher output from uncommitted OPEC+ members and US shale oil producers are downward risks.

Figure 2: International commodity prices



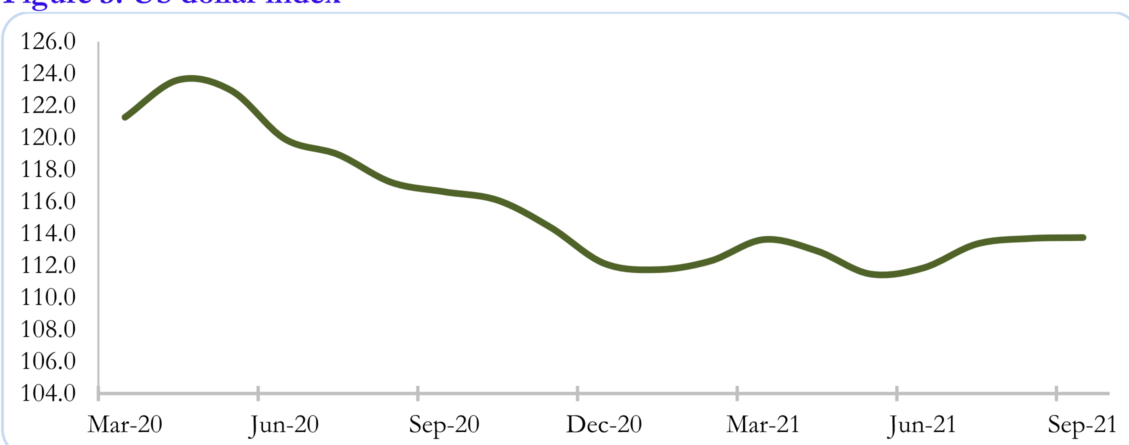
Source: World Bank

1.3 Global financial markets

Global financial market conditions remained generally accommodative despite concerns for higher inflation and likely interest rates hikes in AEs. However, uncertainty looms as economic activity picks up, inflation continues to rise and as some central banks consider tightening monetary policy. The US FED has indicated a possibility of scaling back asset purchases and interest rate hikes in late 2022, while the Economic Intelligence Unit (EIU) projects a gradual policy normalization by the European Central Bank (ECB) in 2022. In the USA, debt default risk has been put off till December 2021, with the senate approving legislation to temporarily raise the federal government's debt limit, while in China, the stock markets are jittery over Evergrande's indebtedness worth about US$ 300 billion.

The US dollar continued to strengthen in the quarter to September 2021 (**Figure 3**) supported by higher nominal interest rates. The 10-year US bond yields that have been falling since May 2021, picked up in September 2021 (**Figure 4**). However, volatility in interest rates has increased, reflecting heightened uncertainty about the inflation outlook and the associated concerns.

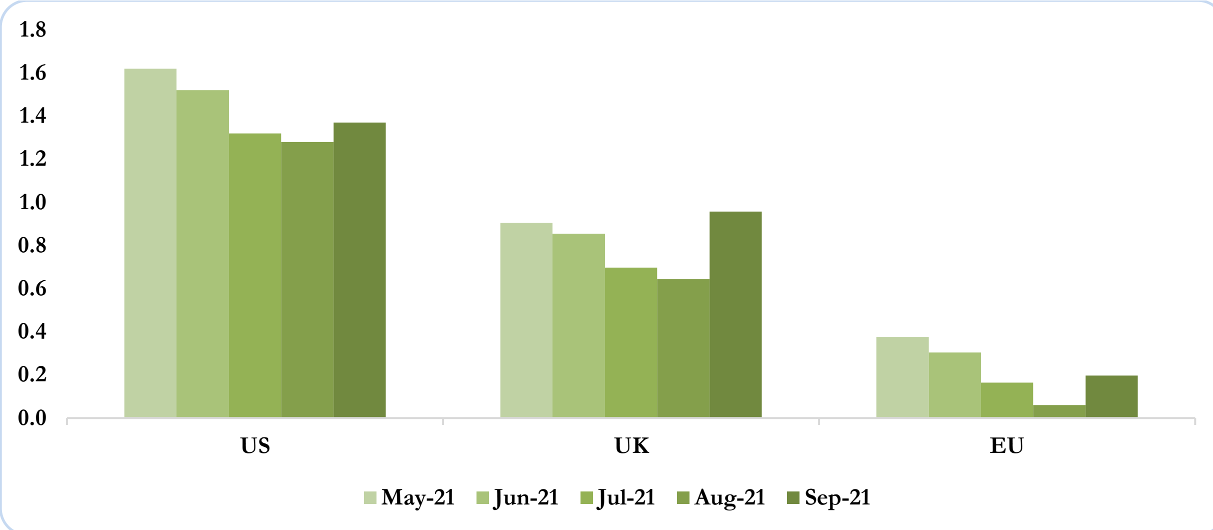
Figure 3: US dollar index



Source: US FED

Persistent inflationary pressures could prompt some central banks particularly in AEs to tighten monetary policy earlier than expected, leading to a disruption in financial markets, including tightening financial conditions for EMDEs amidst limited fiscal buffers.

Figure 4: 10-year government bond yields



Source: US Federal Reserve

2. DOMESTIC DEVELOPMENT AND OUTLOOK

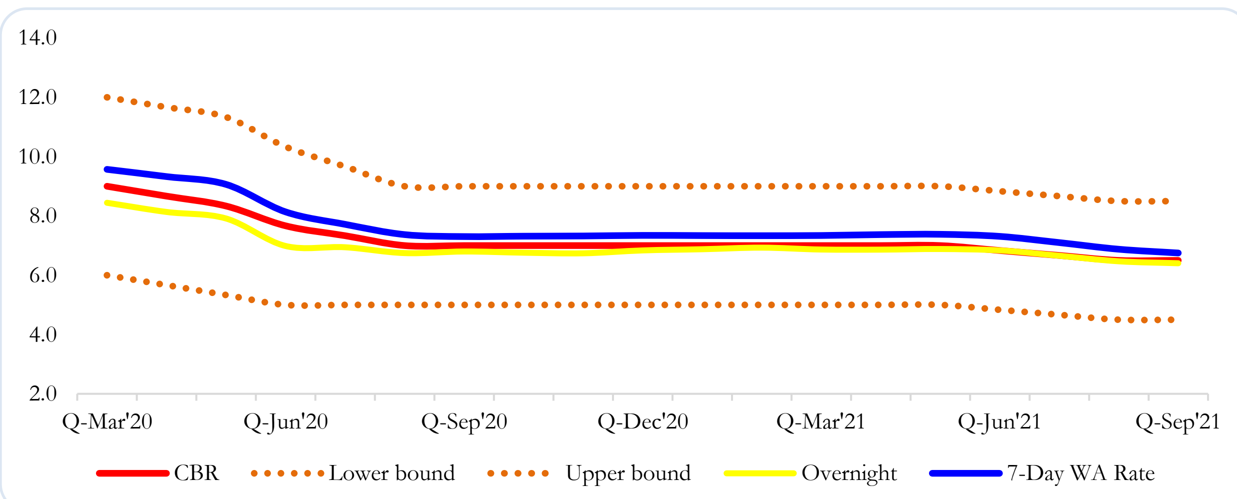
2.1 Domestic financial markets

A developed financial market can efficiently channel liquidity from institutions with surplus funds to those in deficits, provides effective price-discovery mechanism and helps transmit monetary policy to the real economy. A comprehensive assessment of the financial markets is therefore vital for judging the decisions and consequences of the central bank's actions

2.1.1 Interbank money market

Interbank money market rates remained well anchored around the Central Bank Rate (CBR) in the quarter ended September 2021, as shown in **Figure 5**. The 7-day interbank weighted average rate declined to 6.8 percent in the quarter ended September 2021 from 7.3 percent in the quarter ended June 2021, reflecting relatively eased liquidity conditions in the interbank. During the quarter ended September 2021, commercial banks accessed Shs. 105 billion through the Standard Lending Facility (SLF).

Figure 5: Interbank interest rates and Central Bank Rate



Source: Bank of Uganda

2.1.2 Primary market for treasury securities

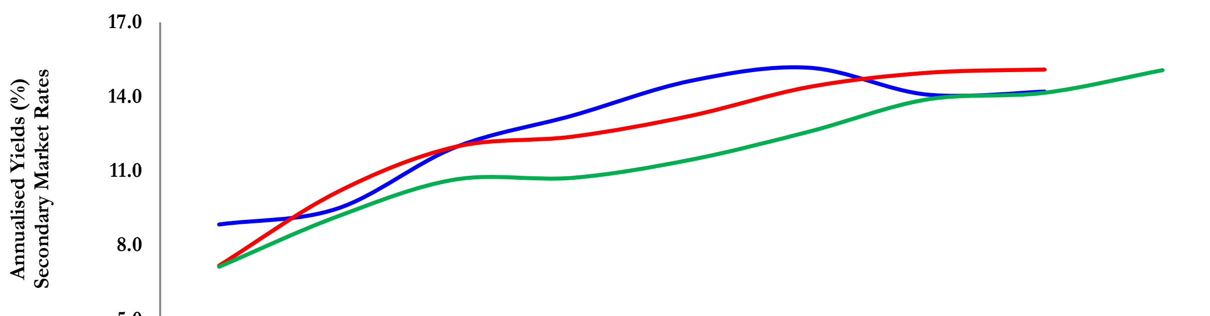
In the primary market, yields on government securities save for the 91-day Treasury bill have moderated, partly reflecting the accommodative monetary policy stance. The average yields on the 182-day and 364-day Treasury bills declined to 8.9 percent and 9.9 percent in the quarter to September 2021 from 9.8 percent and 11.0 percent in the previous quarter. Conversely, yields on the 91-day Treasury bill rates were largely stable rising slightly to an average of 7.2 percent from 7.1 percent over the same period.

The average yields on the 2-year, 3-year, 5-year, 10-year and 15-year Treasury bonds declined to 10.0 percent, 11.4 percent, 13.4 percent, 13.5 percent, and 14.1 percent in the quarter to September 2021 from respective rates of 12.3 percent, 12.8 percent, 15.1 percent, 13.7 percent and 14.4 percent in the previous quarter. The yield on the 20-year bond was 16.0 percent in the quarter to September 2021, down from an average rate of 17.4 in the quarter to March 2021.

2.1.3 Secondary market for treasury securities

The secondary market yield curve for the quarter to September 2021 shifted downwards as rates eased across all the spectrum, in line with the decline in yields observed in the primary market. The average annualised 91-day 182-day and 364-day Treasury bill yields fell to 7.1 percent, 9.2 percent, and 10.7 percent, respectively, in the quarter to September 2021, as shown in **Figure 6**. Similarly, the annualised yields on the 2-year, 3-year, 5-year, 10-year, 15-year and 20-year bonds fell to average 10.7 percent, 11.5 percent, 12.6 percent, 13.9 percent, 14.2 percent and 15.1 percent, respectively, in the quarter to September 2021.

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-Sep'20	8.8	9.5	12.0	13.2	14.6	15.2	14.1	14.2	
Q-Jun'21	7.2	10.1	12.0	12.4	13.2	14.4	15.0	15.1	
Q-Sep'21	7.1	9.2	10.7	10.7	11.5	12.6	13.9	14.2	15.1

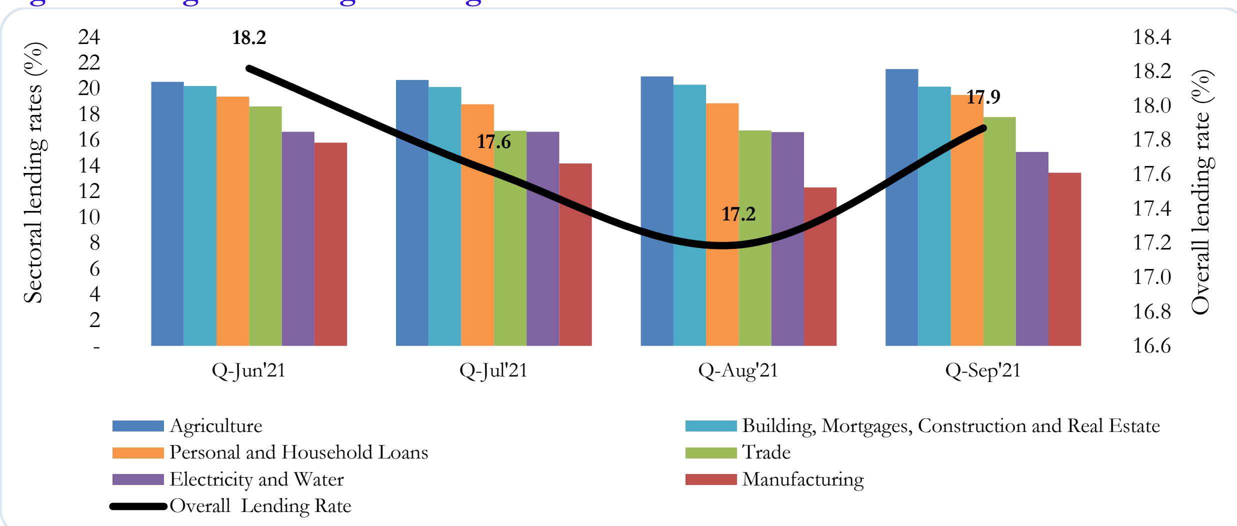
Source: Bank of Uganda

2.1.4 Lending and deposit interest rates

Commercial banks' interest rates declined in the quarter to September 2021 relative to June 2021, largely reflecting the continued support of BOU's accommodative monetary policy stance. The weighted average lending rate on the shilling-denominated loans stood at 17.9 percent, lower than the average of 18.2 percent for the quarter to June 2021. However, relative to August 2021, lending rates rose partly reflecting risk aversion due to uncertainty associated with the adverse impact of pandemic-related restrictive measures and expiry of credit relief measures, as well as deterioration in asset quality.

On a monthly basis, the overall weighted average interest rate on shilling denominated loans increased to 19.0 percent in September 2021 from 18.3 percent in August 2021, with notable increases in rates on loans to the manufacturing and transport & communication sectors, of 4.8 percentage points and 1.6 percentage points, respectively. Interest rates rose for all sectors on a quarterly basis except for the real estate and electricity & water sectors where rates fell by 0.1 percentage points and 1.5 percentage points, respectively, as shown in **Figure 7**.

Figure 7: Weighted average lending rates



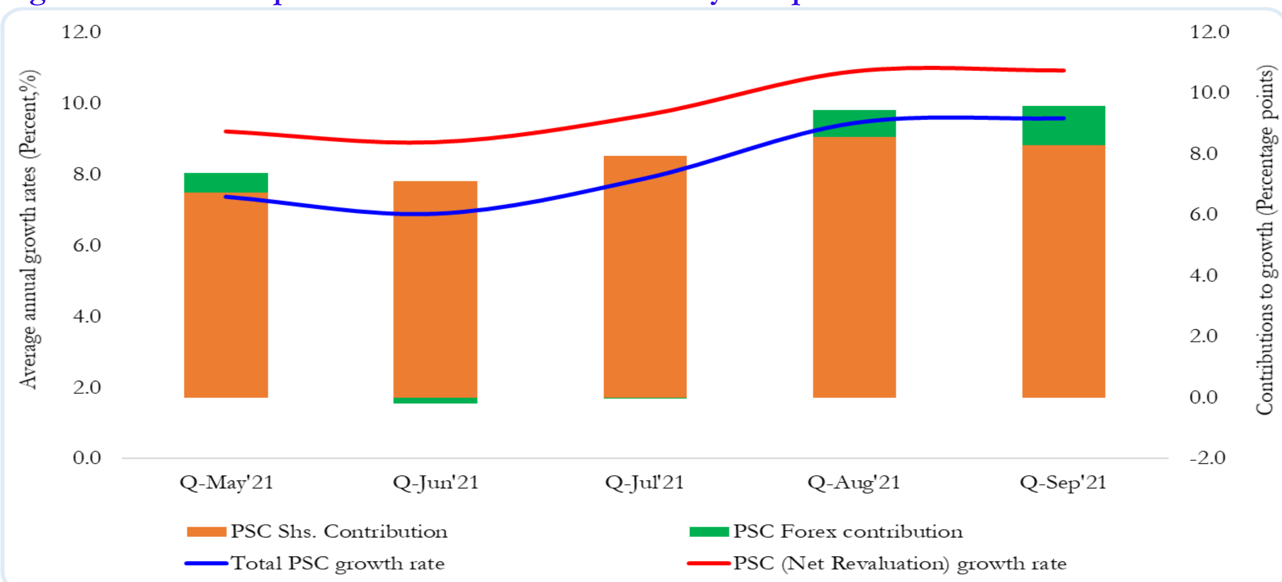
Source: Bank of Uganda

2.1.5 Credit to the private sector

Private Sector Credit (PSC) growth picked momentum in the quarter to September 2021, partly supported by the easing of lockdown in July 2021, accommodative monetary policy stance and credit relief measures put in place by the BoU. Indeed, year-on-year growth in PSC recovered to average 9.6 percent, up from 6.9 percent in the quarter to June 2021. Including loans disbursed by the Uganda Development Bank (UDB), PSC grew by an average of 10.8 percent, on an annual basis, in the quarter to September 2021, up from 8.9 percent in the quarter to June 2021. After adjusting for the exchange rate changes, year-on-year growth in PSC averaged 10.9 percent in the quarter to September 2021 compared to 8.9 percent in the quarter to June 2021 (**Figure 8**). Over the same period, growth in foreign currency-denominated loans improved to 4.1 percent compared to *minus* 0.6 percent in the previous quarter, while shilling denominated loans grew on average by 12.1 percent, up from 10.4 per cent over the same period.

The outlook is for a continued increase in PSC growth as the pandemic is contained and the economic recovery takes root. There are however downside risks to the short-term outlook stemming largely from the continued uncertainty due to the lingering effects of COVID-19 on economic activity and the expiry of the credit relief measures.

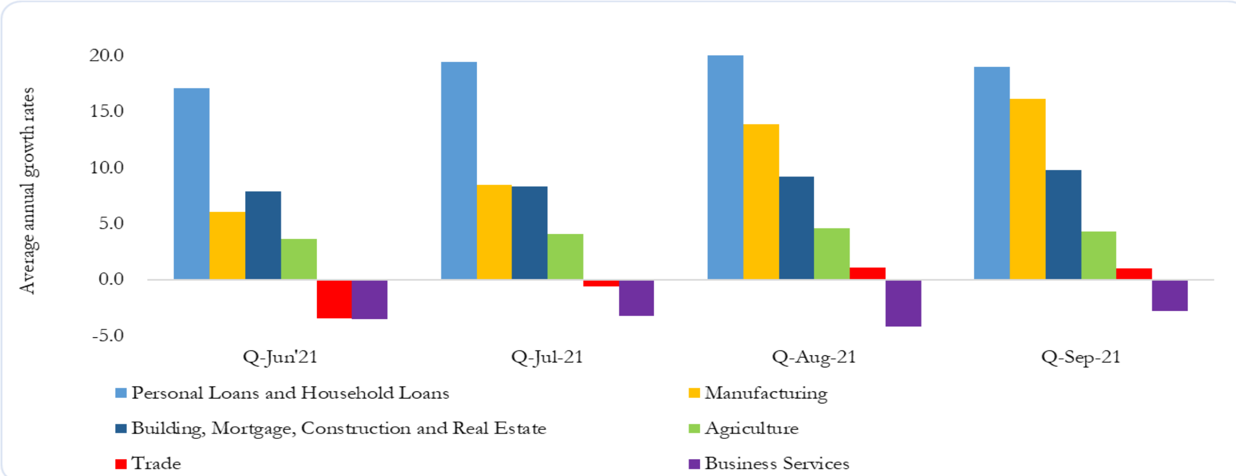
Figure 8: Growth in private sector credit and currency composition



Source: Bank of Uganda

Credit growth in the quarter to September 2021 was dominated by lending to the personal & household, manufacturing as well as the building & real estate sectors, which registered annual growth rates of 19.0 percent, 16.2 percent and 9.8 percent, respectively, up from 17.2 percent, 6.1 percent and 7.9 percent in the quarter to June 2021 (**Figure 9**). Together these three sectors accounted for over half of the total outstanding credit during the quarter. On the contrary, lending to the trade sector, with an average share of 17.4 percent of total outstanding credit in the quarter to September 2021, grew by a paltry average of 1.0 percent annually, up from *minus* 3.5 percent, during the same period. Lending to the business services sector continued on a downward trend.

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

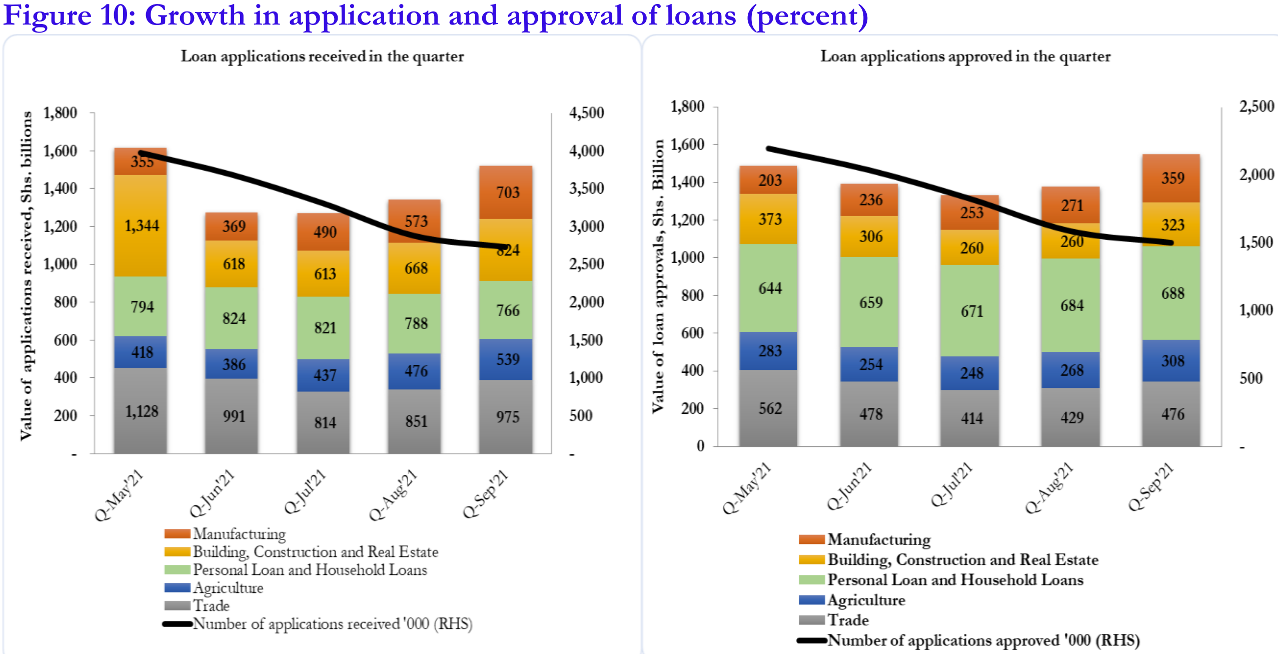


Source: Bank of Uganda

2.1.6 Demand and supply of credit

Demand and supply of credit, improved in the quarter to September reflecting improved economic activity following the easing of the lockdown. The value of loan applications, which is a proxy for demand for credit rose to Shs 4.5 trillion in the quarter to September 2021 from Shs 3.7 trillion in the quarter to June 2021. Similarly, the value of loan approvals, a proxy for supply of credit rose to Shs. 2.6 trillion in the quarter to June 2021 from Shs. 2.3 trillion in quarter to September 2021. Both the number of loan applications and loan approvals have declined since June 2021 (**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 declined, with the share of Non-Performing Loans (NPLs) to total loans rising to 5.4 percent in September 2021 from 4.8 percent in June 2021. The share of NPLs to loans increased for all sectors except manufacturing and mining & quarrying as shown in **Table 2**. The increase in the ratio of NPLs economic sectors is reflective of adverse impact of pandemic related restrictive measures instituted to mitigate the spread of the virus.

Table 2: Non-performing loans by sector

	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21
AGRICULTURE	9.4	8.5	8.2	7.3	4.2	5.7
MINING & QUARRYING	5.6	5.7	7.2	7.6	7.5	1.2
MANUFACTURING	2.2	2.2	2.1	2.6	2.1	1.2
TRADE & COMMERCE	8.9	7.6	8.7	8.0	6.7	6.7
TRANSPORT & COMMUNICATION	2.1	2.1	1.2	3.0	2.3	4.5
BUILDING, CONSTRUCTION & REAL ESTATE	6.5	4.7	4.9	5.7	6.2	7.9
ELECTICITY & WATER	21.6	17.9	18.2	17.1	16.5	17.0
BUSINESS SERVICES	3.5	3.1	3.5	5.2	4.2	4.4
COMMUNITY, SOCIAL AND OTHER SERVICES	2.1	1.2	1.3	1.3	2.3	2.7
PERSONAL AND HOUSEHOLD LOANS	5.0	4.6	4.8	4.4	4.2	4.5
OTHER ACTIVITIES	6.7	6.6	7.5	8.9	8.1	13.5
STAFF LOANS						
OVERALL NPL RATIO	**6.0**	**5.1**	**5.3**	**5.4**	**4.8**	**5.4**

Source: Bank of Uganda

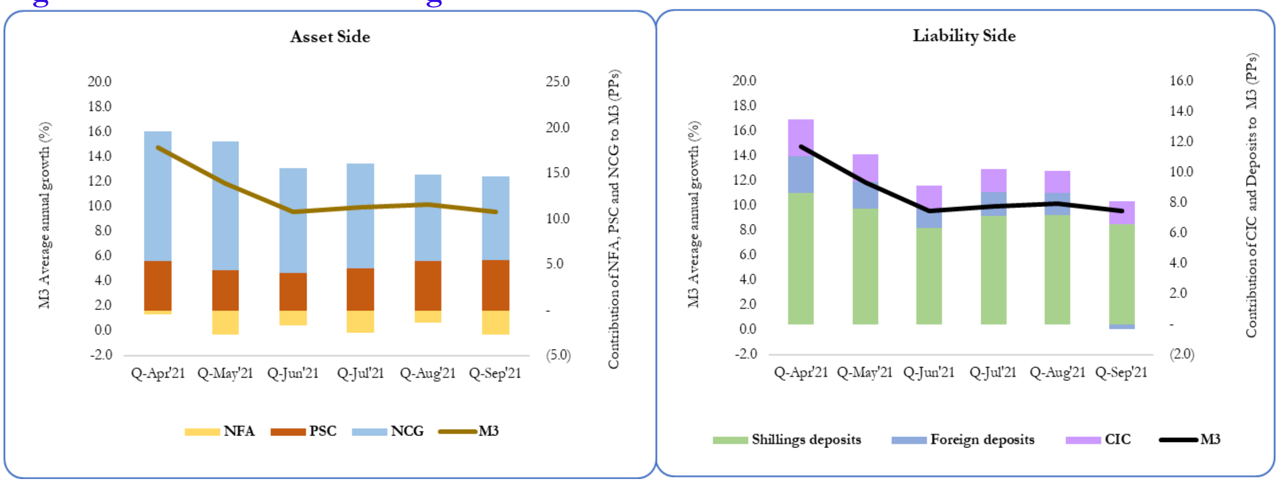
2.1.8 Money supply

Growth in monetary aggregates was sluggish in the quarter to September 2021 partly reflecting the slowdown and gradual pickup in economic recovery. The average annual growth in M3 stood at 9.6 percent, the same growth for the quarter ended June 2021. While growth in foreign currency denominated deposits was lower at 5.2 percent from 6.0 percent, primarily reflecting the appreciation of the exchange rate, shilling denominated deposits grew slightly higher by 11.9 percent relative to 11.6 percent.

M2 growth slightly increased to 11.3 percent in the quarter to September 2021 relative to 11.1 percent in the quarter to June 2021 due to the pick-up in demand deposits as well as currency in circulation, which offset the weakening of time and saving deposits. The average growth in demand deposits and currency in circulation rose to 15.7 percent and 9.5 percent, respectively, up from 8.7 percent and 9.4 percent, while growth in time and savings deposits fell to 9.1 percent from 14.0 percent.

The contribution of Net Domestic Assets (NDA) to growth in M3 rose in the three months to September 2021 relative to the previous quarter. NDA contributed 12.2 percentage points, higher than the 11.2 percentage points contribution registered in the quarter to June 2021. On the other hand, the contribution of Net Foreign Assets (NFA) to growth in M3 fell to *minus* 2.6 percentage points compared to a *minus* 1.7 percentage points contribution in the previous quarter. The contribution of Net Claims on Government (NCG) to growth in M3 declined in the quarter to September 2021 to 9.2 percentage points from 11.5 percentage points, while that of PSC rose to 5.5 percentage points, up from 4.1 percentage points over the same period (**Figure 11**).

Figure 11: Contributions to M3 growth



Source: Bank of Uganda

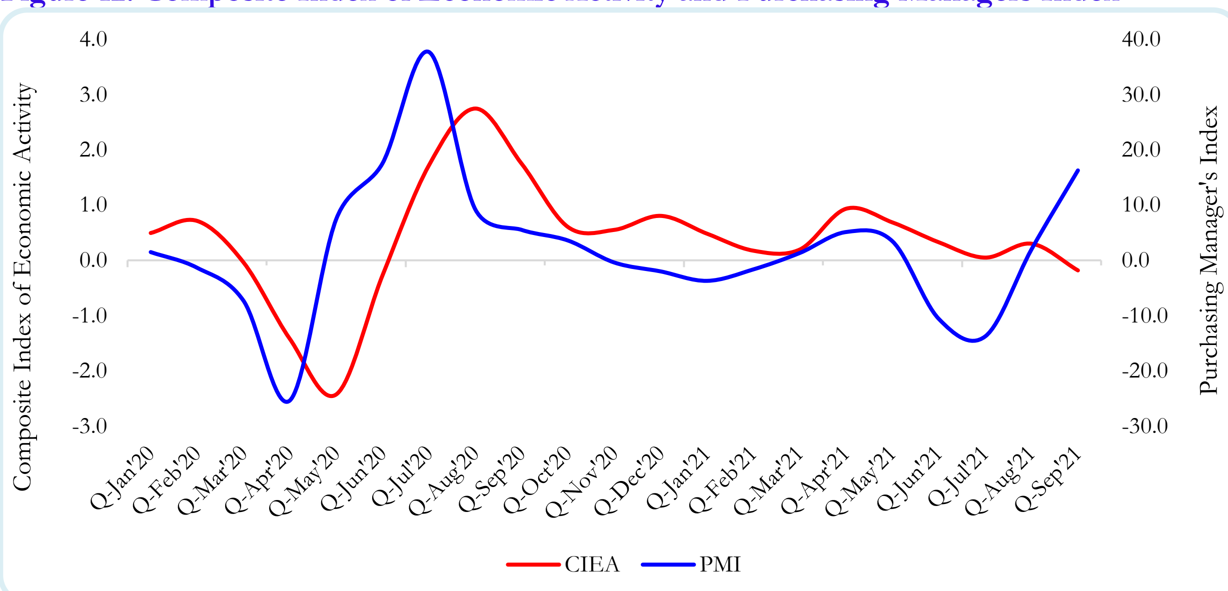
2.2 Domestic economic activity

Although monetary policy lives 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. Therefore, a comprehensive assessment of economic is important judge both the stance and consequences of monetary policy.

The phased relaxation of the second COVID-related restrictions amidst improving positivity rates in July 2021 resulted in a pick-up in economic activity. The effects of the pandemic related containment measures had disrupted the recovery in economic activity with growth estimated to have declined in September 2021, although by less than the decline following the first lockdown in March 2020.

Indeed, leading indicators of economic activity show that the economic recovery is on course, albeit at a slower pace than previously observed. On a monthly basis, the Composite Index of Economic Activity (CIEA) deteriorated by 0.5 percent in September 2021 a continuation to the 0.3 percent decline observed in August 2021, resulting into an average of *minus* 0.2 percent in the quarter to September 2021, down from 0.7 percent growth in the quarter to May 2021. The IHS Markit Purchasing Managers' Index (PMI) rose to 52.5 in September 2021 from 50.2 in August 2021. The increase in the PMI reflects positive business sentiment amid expectations of improvements in consumer demand. The average quarterly percentage changes in the CIEA and PMI are as shown in **Figure 12**.

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



Source: Bank of Uganda and Stanbic IHS Markit PMI

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, while fiscal contraction can help cool down an overheating economy. Therefore, coordination of fiscal and monetary policies plays a crucial role in the overall macroeconomic management and the attainment of sustainable economic growth.

2.3.1 Expenditure and revenue

Fiscal operations for the first quarter the FY2021/22 were constrained by revenue shortfalls. Relative to the Uganda Revenue Authority (URA) target, total tax revenue underperformed by Shs. 560.7

billion (**Table 3**) as shortfalls were registered in all tax heads except stamp duty. Direct domestic taxes, indirect domestic taxes, and international trade taxes underperformed by Shs. 11.4 billion, Shs. 300.9 billion and Shs. 106.5 billion, respectively. Other domestic taxes, including Corporate tax and Rental Income tax registered shortfalls of Shs. 24.7 billion and Shs. 19.5 billion, respectively. Pay as You Earn (PAYE) however, registered an impressive performance of Sh.70.8 billion above the target.

Table 3: Revenue performance (billion shilling)

	URA Target Jul'21-Jun'22	Cumulative Outturn Jul-Sep'21	Cumulative Target Jul-Sep'21	Jul-Sep'21 Variation from Target	Outturn vs Target
Total Net Tax & Non-Tax Revenue	22,425.4	4,459.8	4,972.6	(512.9)	89.7
Net URA Tax Revenue (excluding refunds)	20,876.9	4,255.5	4,617.0	(361.5)	92.2
Gross Revenues	22,864.5	4,521.7	5,082.4	(560.7)	89.0
Direct Domestic Taxes	7,413.9	1,347.0	1,358.3	(11.4)	99.2
Indirect Domestic Taxes	5,689.5	1,079.0	1,379.9	(300.9)	78.2
o/w mobile money transfers	125.1	30.9	27.8	3.0	110.8
o/w Levy on mobile money withdrawals	112.4	36.7	31.1	5.6	118.0
Taxes on International Trade	8,140.5	1,866.2	1,972.7	(106.5)	94.6
o/w Petroleum duty	2,617.3	587.4	630.7	(43.3)	93.1
o/w Import duty	1,676.5	337.2	405.5	(68.3)	83.2
o/w Export levy	77.7	2.8	30.1	(27.3)	9.3
Stamb Duty and Embrossing Fees	72.2	25.3	15.8	9.5	160.5
Non Tax Revenue	1,548.4	204.3	355.6	(151.4)	57.4
Tax Refunds	(439.1)	(62.0)	(109.8)	47.8	56.5

Source: Uganda Revenue Authority

Preliminary fiscal indicators indicate that government expenditure for the quarter of September 2021 underperformed by Shs. 1,909.1 billion relative to the programmed expenditure, mainly due to an under performance in development expenditure (**Table 4**). Development expenditure underperformed by Shs. 2,289.8 billion due to slow absorption by some government projects while current expenditure was higher than programmed by Shs. 281.3 billion. The payment of arrears was Shs. 115.1 billion above target on account of government's continuous effort to cushion its suppliers against the effects of the pandemic by clearing more arrears than budgeted.

The developments in government revenue and expenditure resulted in a fiscal deficit of Shs. 2,294.7 billion, which was lower than the programmed deficit by Shs. 1,197.9 billion.

Table 4: Fiscal operations (billion shilling)

	Jul-Sep'20	Jul-Sep'21	Approved Budget Jul-Sep'21	Variation Q3	Annual Change (%)
Revenue and Grants	**4770.8**	**4623.7**	**5335.0**	**-711.3**	**-3.1**
Revenue	4119.3	4459.7	4972.6	-512.9	8.3
Grants	651.5	164.0	362.3	-198.3	-74.8
Expenditure and Lending	**8894.8**	**6918.4**	**8827.5**	**-1909.1**	**-22.2**
Current expenditure	4988.8	4464.3	4182.9	281.4	-10.5
o/w Interest payments	1243.9	1165.5	1165.5	0.0	-6.3
Domestic	832.6	873.4	873.4	0.0	4.9
External	411.3	292.1	292.1	0.0	-29.0
Development Expenditure	3055.2	2186.6	4476.5	-2289.9	-28.4
Net lending/Repayments	545.6	10.8	26.5	-15.7	-98.0
Domestic arrears repayment	305.1	256.8	141.6	115.2	-15.9
Primary Deficit	**-2880.1**	**-1129.2**	**-2327.0**	**1197.8**	**-60.8**
Deficit (excluding grants)	**-4775.5**	**-2458.6**	**-3854.9**	**1396.3**	**-48.5**
Deficit (including grants)	**-4124.0**	**-2294.7**	**-3492.6**	**1197.9**	**-44.4**
Financing (net)	**4124.0**	**2294.7**	**3492.6**	**-1197.9**	**-44.4**
External Fianacig (net)	2410.9	531.4	838.4	-307.0	-78.0
Domestic Financing (net)	1333.5	1322.7	2654.1	-1331.4	-0.8
Errors and Ommisiions	379.6	440.6	0.0		

Source: Ministry of Finance Planning and Economic Development

2.3.2 Public debt stock

Provisional statistics on total public debt stock (in nominal terms) at end-September 2021 stood at Shs. 72,667.3 billion, a 1.5 percent increase from June 2021 compared to an increase of 15.6 percent the same period last year. The increase in debt between June 2021 and September 2021 was largely due to Shs. 1,567.4 billion increase in domestic debt. Public external debt continued to maintain the dominant share of 61.1 percent of the total public debt. Debt service to tax revenue ratio has gradually increased to 27.2 percent in September 2021 up from 24.8 percent in June 2021, higher than 24.1 percent observed in September 2020.

Going forward, Government is expected to increase expenditure in the quarters ahead to support the recovery of economic activity, which is likely to result into front loading of Net Domestic Financing (NDF) while waiting for budget support inflows. Indeed, the Government has already appropriated Shs. 11.9 trillion as part of its quarterly release for domestic expenditure for the second quarter of FY2021/22.

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 a depreciation of the exchange rate. Persistent CA deficits may, however, require structural changes in the economy to enhance domestic productivity relative to the rest of the world.

Uganda's Balance of Payment account recorded a surplus in the quarter to September 2021 that resulted into a US$276.4 million build up in reserve assets. This position is slightly higher than the surplus of US$ 207.6 million recorded in the quarter to June 2021 (**Figure 13**). The continued improvement in the overall balance of payments surplus position was largely supported by a new Special Drawing Rights (SDR) allocation from the IMF as well as increased foreign direct investments.

The current account deficit improved, registering an increase of 36.7 percent to US$ 809.5 million compared to a deficit of US$ 1,277.8 million in the quarter to June 2021, primarily due to contraction in the trade deficit. The trade deficit narrowed, by 37.4 percent to US$ 643.7 million, as both exports and imports declined, reflecting subdued economic activity.

The import bill narrowed by 36.5 percent to US$ 1,528.7 million, outweighing the contraction in export receipts of 35.9 percent to US$ 885.0 million. Earnings from major export commodities such as, cotton, tobacco, tea, maize, fish, simsim, hides, cement, cocoa beans and sugar decreased. Expenditure on main imports categories such as, investment (gold, plastics, oil, machinery), consumption (vegetables, animal products) and project related government imports declined, due to depressed domestic demand. In addition, a tax levy introduced in July 2021, of 10 percent and 5 percent on each kilogram of unprocessed and refined gold exports respectively, resulted into a significant drop in gold exports worth US$531.8 million in the quarter to September 2021.

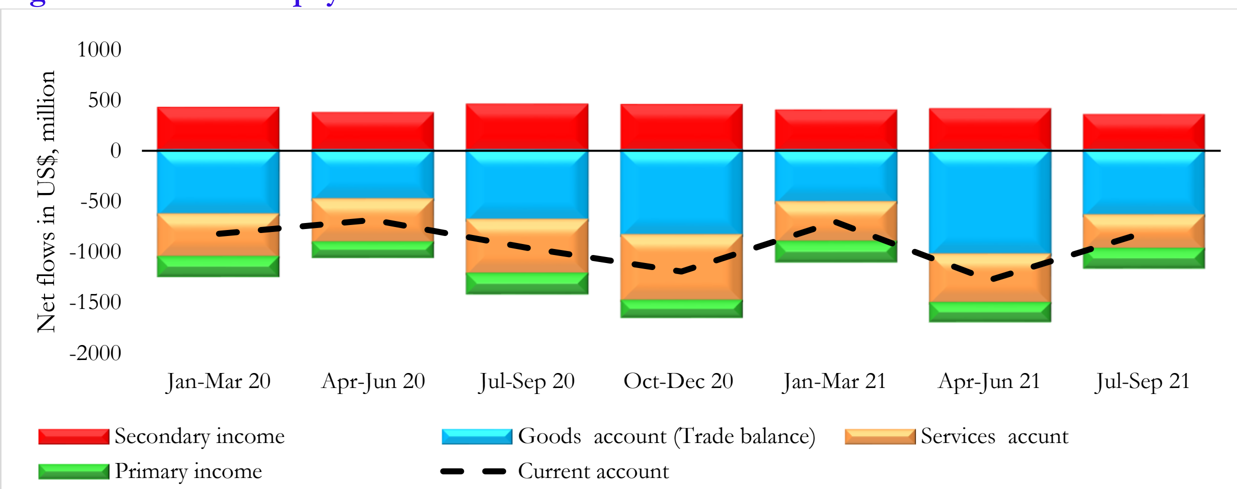
The services account deficit narrowed by 30.6 percent to US$332.9 million, largely attributed to lower transport service payments to non-residents, consistent with the contraction in the import bill. The primary income account deficit deteriorated by 2.6 percent to US$178.4 million, mainly due to increase in debt service, specifically interest payments on public debt. Remittance inflows slowed to US$ 242.8 million in the quarter to September 2021 from US$ 266.1 million in the quarter to June 2021, leading to a reduction in the secondary income account surplus.

The current account deficit was adequately financed by financial account inflows. An SDR allocation equivalent to US$ 493.4 million was allocated to Uganda within the quarter, resulting into a 28.6

percent expansion in net inflows of US$789.5 million into the other investment account. In addition, foreign direct investment increased by US$90.1 million to US$302.0 million in the quarter to September 2021, up from net inflows of US$211.9 million in the previous quarter. On the other hand, portfolio investment slowed, recording a net inflow of US$ 137.1 million, slightly lower than a net inflow of US$ 137.7 million in the quarter to June 2021, driven by a decline in the entry of offshore investors into the domestic debt securities market. Despite this improvement, FDI inflows remained below pre-pandemic levels.

The financial account therefore recorded a net surplus position of US$ 1,229.0 million leading to a reserve build-up in the quarter to September 2021.The stock of reserves increased to US$ 4.4 billion, in the quarter to September 2021, which was equivalent to 4.5 months of future imports of goods & services.

Figure 13: Balance of payments



Source: Bank of Uganda

In the short term, the current account deficit is likely to deteriorate, as import growth is anticipated to respond to the recovery in economic activity and the looming festive season. However increased external demand in combination with the continued strong performance of coffee exports will support the trade balance. The deterioration in the services sector may persist due to subdued travel service receipts, as travellers remain cautious of emerging strains of the corona virus. Increased transport service debits are expected in line with the import growth. Income account deficit will narrow further as net outflows of investment income and compensation of employees are likely to reduce in response to lower returns and disruptions in the labour market, respectively. In addition, higher remittance inflows are expected in line with the festive season leading to a narrowing of the current account deficit.

The financial account surplus is likely to widen as higher donor inflows as well as loan disbursements to support economic recovery are expected. Foreign Direct Investment (FDI) inflows and related financial inflows are likely to remain subdued reflecting slow recovery of global investor confidence and private capital flows. Portfolio flows are likely to remain jittery reflecting investor sentiments and expectation of interest rate hikes in AEs amidst persistent inflationary pressures.

In the medium term, the balance of payments outlook is contingent on the evolution of the coronavirus pandemic globally and domestically. It is expected that the current account deficit will improve as exports, tourism receipts and remittance inflows recover. The trade deficit is likely to improve as the recovery in AEs are expected to spur external demand. The services deficit is expected to narrow as tourism receipts increase due to successful vaccination drives in both the source and recipient countries as well as resumption in passenger flights. Income account deficit is likely to widen to support improvements in the labour market and support corporate profit growth. The secondary income is expected to improve as stronger remittance inflows are anticipated as economic activity and job markets in advanced economies recover.

The financial account surplus is expected to widen due to developments in the oil sector in preparation for first production in the FY 2024/25, which are expected to improve investor prospects, thereby strengthening FDI and related financial inflows. Loan disbursements are expected to increase to support new and existing public sector projects. However, a turnaround in portfolio investments to pre-pandemic levels is likely driven by expected monetary policy normalization in AEs.

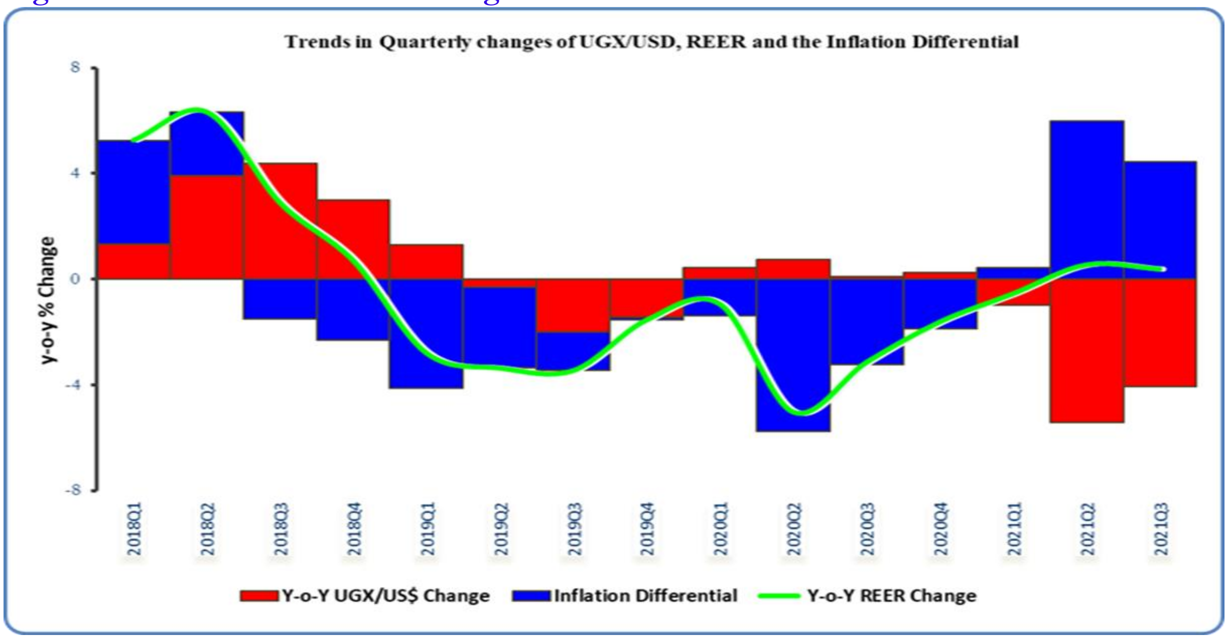
2.4.2 Exchange rates

The Uganda Shilling continued to strengthen against the US Dollar into the quarter to September 2021, although depreciation pressures emerged towards the end of the quarter. The Shilling appreciated on account of high remittance inflows and transfers from Non-Governmental Organizations (NGOs), strong portfolio inflows from offshore players looking for higher yields on treasury securities and increased export earnings particularly from coffee and tea exports. The exchange rate appreciated by 4.1 percent year-on-year and by 0.9 percent month-on-month to an average mid-rate of Ushs. 3,540 per US dollar in the quarter to September 2021, from an appreciation of 5.2 percent year-on-year and 2.8 percent month-on-month, in the quarter to June 2021.

The depreciation in the last three days of September 2021 was on account of the strengthening of the US dollar against major international currencies, the recovery of domestic demand and bearish sentiments in anticipation of offshore demand which prompted banks to cover their short dollar positions. In the near term, the shilling is expected to depreciate against the US dollar, in part, due to a pickup in import demand in line with the recovery in economic activity.

On a trade-weighted basis, the Real Effective Exchange Rate (REER) depreciated by 0.4 percent year-on-year but appreciated by 0.7 percent month-on-month, on account of inflation differential. The exchange rate developments are presented in **Figure 14**.

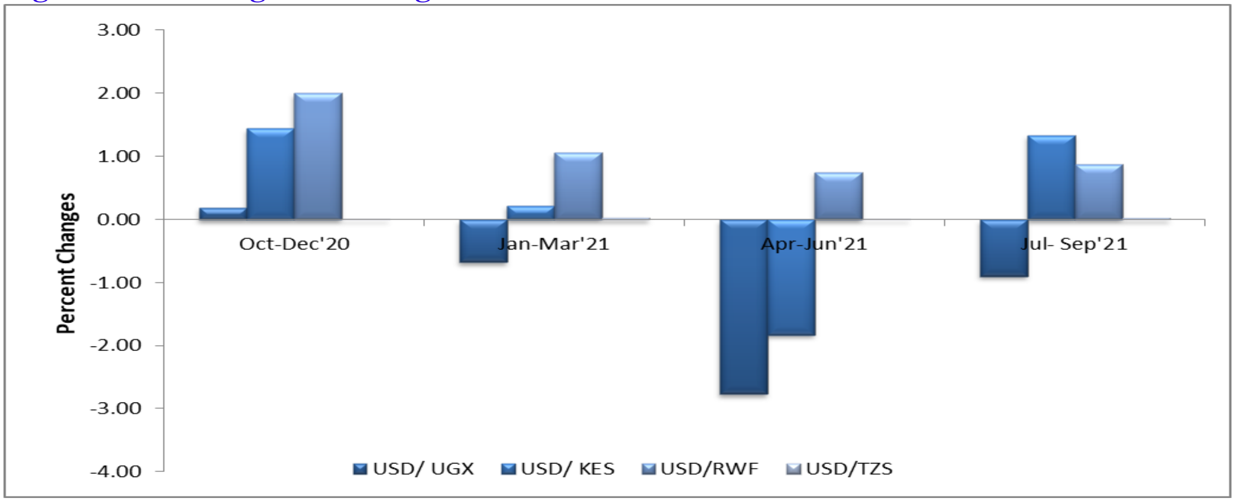
Figure 14: The real effective exchange rates



Source: Bank of Uganda

In the quarter to September 2021, currencies of other East African Community (EAC) states depreciated against the US dollar as shown in **Figure 15**. On average, the Tanzania Shilling remained relatively stable at an average rate of TZ 2,299.24 per US dollar, while the Kenya Shilling and the Rwanda Franc depreciated by 1.3 percent and 0.9 percent respectively, to average mid-rates of KES 109.2 and RWF 991.9 per US dollar, respectively.

Figure 15: Exchange rate changes in selected EAC countries



Source: Bank of Uganda

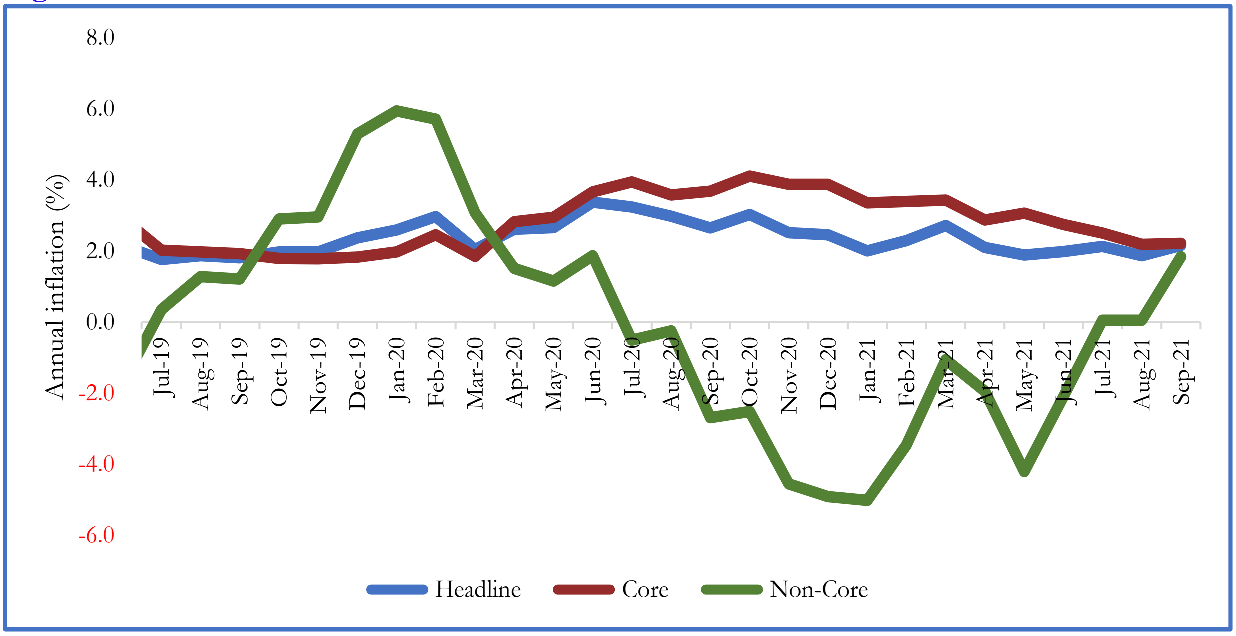
Domestic inflation is driven by both domestic and external economic factors. A careful assessment of the evolution and outlook of domestic is therefore critical for the design of appropriate monetary policy strategy, which in Uganda, is formulated to deliver a medium-term core inflation target of 5 percent and to ensure that output is not only as close to potential as possible, but also consistent with the inflation objective.

2.5 Inflation and outlook

Disinflation has persisted since October 2020, in part reflecting spare capacity in the economy. Headline and core inflation averaged 2.3 percent and 3.1 percent, respectively, in the 12 months to September 2021, which is below the BoU's medium-term target of 5 percent. On a monthly basis, the annual headline inflation edged slightly higher to 2.2 percent in September 2021 from 1.9 percent in August 2021, in part reflecting an increase in food crop prices. However, annual core inflation remained unchanged at 2.2 percent, primarily due to a decrease in prices for services even though goods inflation rose (**Figure 16**).

The major driver of annual headline inflation was the food crops and related items categories inflation, which increased to 3.2 percent in September up from 0.5 percent in August 2021. Specifically, increases in the prices of vegetables, tubers, plantains, cooking bananas and pulses were registered in the month of September. In addition, liquid energy fuels inflation rose to 4.8 percent from 2.2 percent leading to an increase in Energy Fuel and Utilities (EFU) inflation to 0.2 percent in September 2021 up from *minus* 0.5 percent in August 2021. On the contrary, annual services inflation declined to 1.8 percent in September 2021 down from 2.5 percent recorded in the previous month, reflecting low activity in service-led sectors, while the annual other goods inflation increased to 2.5 percent in September 2021 up from 1.9 percent in August 2021.

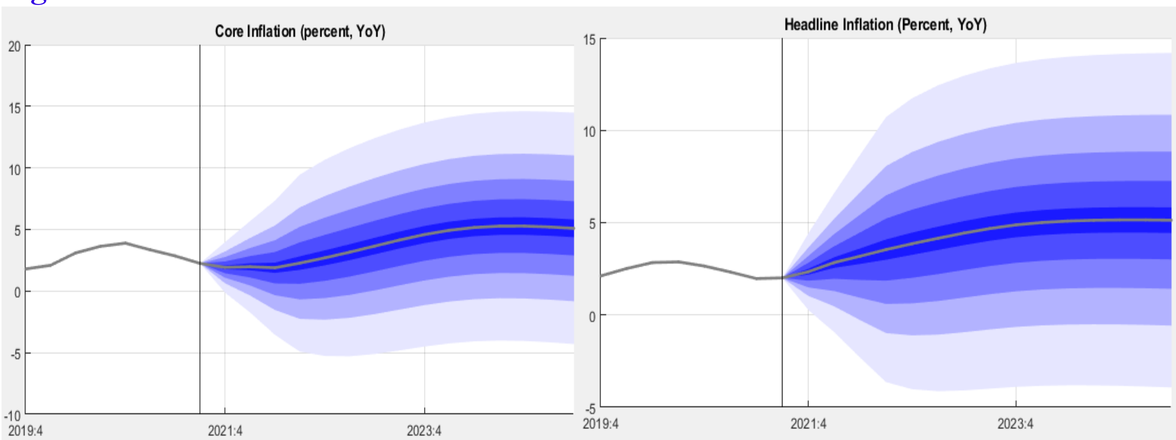
Figure 16: Domestic inflation



Source: Uganda Bureau of Statistics

Inflation projections in the October 2021 forecast round are lower than in the August 2021 forecast round. Core inflation is forecast to average 2.6 percent in 2021 and 2.2 percent in 2022, while Headline inflation is forecast to average 2.2 percent in 2021 and 3.4 percent in 2022. Inflation might rise gradually in the near-term due to temporary effects of the COVID-19 containment measures but will remain below the 5 percent target in the medium-term as excess capacity continues to exert downward pressure on prices. In the medium-term, as demand recovers with the full reopening of the economy and the release of pent-up demand, inflation is forecast to rise but stabilise around the 5 percent target **(Figure 17).**

Figure 17: Baseline inflation forecast



Source: Bank of Uganda

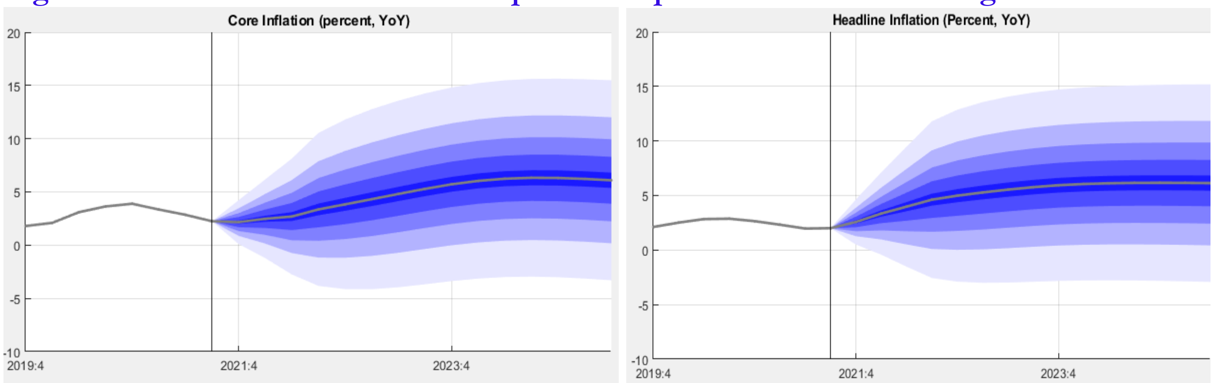
The forecasts in the baseline scenario are premised on several revisions of external and domestic assumptions of the previous forecast round. Regarding external assumptions, global growth is revised downwards, while inflation remained relatively unchanged and the Fed funds rate is expected to increase sooner than previously anticipated. Oil prices are expected to remain around US$ 70 per barrel in 2021 but gradually decelerate later due to an increase in production by OPEC-plus countries and possible entry of Iran into the global oil market. International food prices are expected to decline from the peak in 2021 and gradually increase going forward, reflecting a pickup in demand. The first expected interest rate increase is in 2022Q4, one quarter earlier than previously assumed. On the domestic scene, the assumption on domestic economic activity remained unchanged from the previous forecasting round. However, the fiscal path was revised to reflect a tighter fiscal path in the FY2022/23.

The outlook for inflation is subject to risks. BOU assesses that the risks are tilted to the upside. A more depreciated exchange rate, higher international commodity prices and higher services inflation could put upward pressures on domestic inflation. On the downside however, lower domestic growth conditional on a third and fourth waves of the pandemic despite plans to vaccinate half the population by 2022 and persistent spare capacity could exert downward pressure on domestic inflation.

Despite the upside risks, the alternative scenario forecasts show that inflation will not significantly deviate from the 5 percent target. For instance, if the exchange rate depreciates by 3 percent over the forecast horizon, headline inflation is on average 0.9 percentage points higher than the baseline in

2022. Core inflation is on average 0.1 percentage points and 0.9 percentage points higher than the baseline in 2021 and 2022, respectively **(Figure 18).**

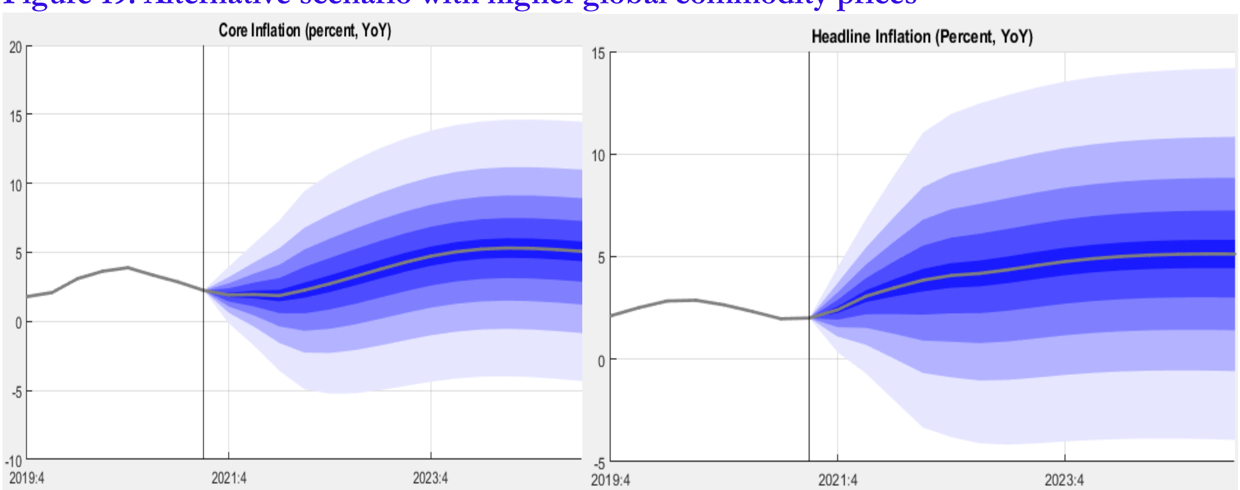
Figure 18: Alternative scenario with 3 percent depreciation of the exchange rate



Source: Bank of Uganda

In the event of higher global commodity prices, headline inflation would on average be 0.3 percentage points higher than in the baseline scenario in 2022 **(Figure 19)**. Non-core inflation would increase by 2 percentage points and 5 percentage points in 2021Q4 and 2022Q1, respectively**.**

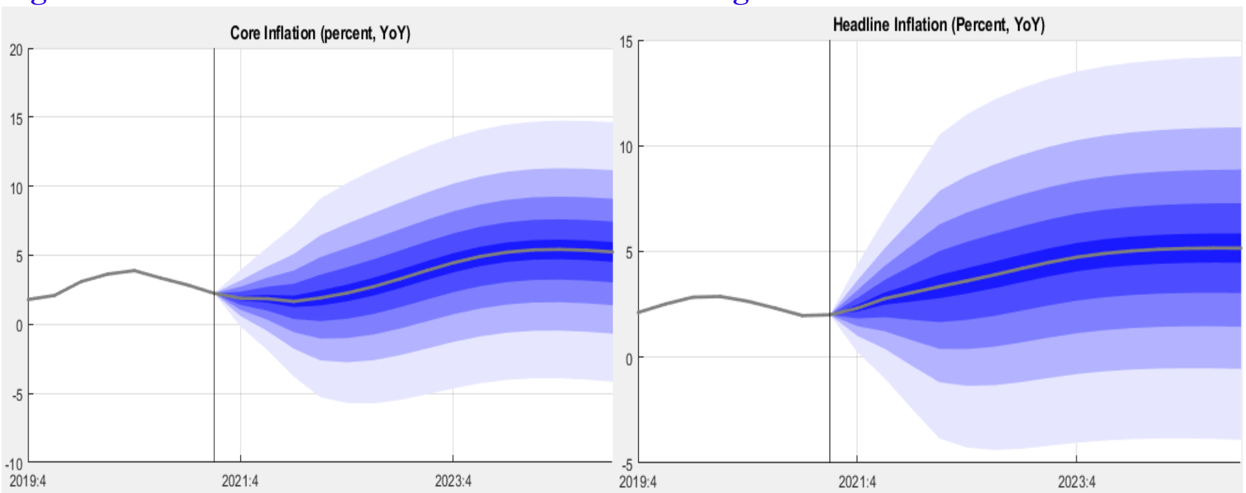
Figure 19: Alternative scenario with higher global commodity prices



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, respectively. Similarly, core inflation would average 0.3 percentage points lower than in the baseline in 2022 and 2023, respectively **(Figure 20).**

Figure 20: Alternative scenario with weaker economic growth



Bank of Uganda

3 MONETARY POLICY DECISION

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 levels and targets is thus crucial to determine an appropriate forward-looking monetary policy strategy.

The second wave of the Covid-19 pandemic interrupted the recovery of the economy and real GDP growth momentum is expected to have declined in the September 2021 quarter as a result of the COVID-related restrictions, although by less than the first national lockdown in the second quarter of 2020. With the waning of the second wave, a phased relaxation of the pandemic-related restrictions, and improving vaccine coverage, economic activity is gradually normalising. However, some contact-dependent sectors that faced the brunt of the pandemic continue to face difficult conditions.

The pandemic continues to pose uncertainty in the near-term economic outlook. Economic growth will depend on the release of pent-up demand, a boost to investment activity from the government's focus on infrastructure and support to sectors that have been more adversely affected by the pandemic, and accommodative monetary conditions. Economic growth is projected in the range of 3.5-3.8 percent in Financial Year (FY) 2021/22, slightly lower than the August 2021 round of forecast. However, as vaccination rates increase further and the health-related restrictions are eased, the economy is expected to bounce back strongly. Economic growth is projected at 5.5-6.0 percent in FY2022/23, increasing to 6.5-7.5 percent in the medium-term (2 to 3 years ahead). A rebound of economic activity will be sustained by an acceleration in private consumption, strong growth in external demand, a gradual return of tourism, and foreign and domestic private investment in the oil sector.

The outlook remains overcast by the future path of the pandemic, especially a major mutation of the virus that could severely undermine vaccine effectiveness and delay both domestic and global economic recovery. Moreover, considerable uncertainty exists regarding the longer-run economic impact of the COVID-19 pandemic. Furthermore, private sector credit extension remains sluggish due to perceived risk that continues to significantly impair private investment, compromising the quality of financial market information and lenders' ability to assess the viability of borrowers and investment projects. In addition to spillovers from the rising commodity prices, especially of crude oil and other inputs, global supply chain disruptions could restrain economic growth in the near-term.

Disinflation has persisted since October 2020, in part reflecting spare capacity in the economy. Notwithstanding the COVID-19-related restrictions and the recent exchange rate depreciation pressures, inflation forecasts indicate that inflation will remain within the 5 ± 3 percent target. Inflation is projected to remain below target in the near-term, as excess capacity continues to exert downward pressure on prices. In the medium-term, as demand recovers with the full reopening of the economy and the release of pent-up demand, inflation is forecast to rise but stabilize around the 5 percent target, contingent on the evolution of the pandemic and the efficacy of vaccines.

Uncertainty around the inflation projection remains high. Global producer price and food price inflation have risen sharply in recent months and could persist. Additionally, international commodity prices, especially oil and other inputs prices, have been on an upward surge since May 2020 and could rise beyond what the current projections assume. These developments could accentuate domestic cost pressures. Furthermore, the risk of currently elevated inflation in most of the advanced economies could necessitate an early exit from accommodative monetary policies. The resultant heightened volatility in global financial markets could lead to capital outflow and exert a stronger weakening of the shilling, while the economy is still at a relatively early stage of recovery. On the downside, a faster resolution of global supply chain disruptions, softer international commodity prices, and another round of good food crop harvest could cause inflation to remain subdued.

The Monetary Policy Committee (MPC) assessed that inflation remains benign, that the risks to the economic growth outlook are skewed to the downside and that there remains considerable excess capacity in the economy. The MPC stressed that there is a persistence of high uncertainty and that economic and financial conditions are expected to remain volatile in the short to medium term. Against this backdrop, the MPC judged that keeping the CBR unchanged at 6.5 percent would be consistent with meeting the inflation target of 5 percent sustainably in the medium term. The band on the CBR is also maintained at +/-2 percentage points on the CBR and the margins on the rediscount rate and bank rate have been kept unchanged at 3 and 4 percentage points on the CBR, respectively. Consequently, the rediscount rate and the bank rate have been maintained at 9.5 percent and 10.5 percent, respectively.