

Bank of Uganda



Monetary Policy Report

August 2016

Table of Contents

List of Figures.....	iii
List of Tables.....	iii
Acronyms and Abbreviations.....	iv
Executive Summary.....	vi
1 Reflections of Monetary Policy in the Previous Period.....	1
1.1 Monetary Policy Stance.....	1
1.2 Monetary Policy Implementation.....	1
2 Money and Financial Markets Developments.....	2
2.1 Global Financial Markets.....	2
2.2 Domestic Financial Markets.....	3
2.2.1 <i>Interbank Money Market</i>	3
2.2.2 <i>Primary Market for Treasury Securities</i>	4
2.2.3 <i>Secondary Market for Treasury Securities</i>	5
2.2.4 <i>Lending and deposit interest rates</i>	6
2.2.5 <i>Private Sector Credit</i>	7
2.2.6 <i>Other Monetary Aggregates</i>	9
3 Economic Activity.....	10
3.1 Global Economic Activity.....	10
3.2 Domestic Economic Activity.....	12
4 Fiscal Policy and Developments.....	13
4.1 Government Expenditure and Revenue.....	13
4.2 Public Debt Stock.....	15
5 Balance of Payments and Exchange rate Developments.....	16
5.1 Balance of Payments.....	16
5.1.1 <i>Current Account Developments</i>	16
5.1.2 <i>Capital and Financial account</i>	17
5.2 Exchange Rate Developments.....	18
6 Inflation.....	20
6.1 Global Inflation and International Commodity Prices.....	20
6.1.1 <i>Global Inflation</i>	20
6.1.2 <i>International Commodity Prices</i>	20
6.2 Domestic Consumer Price Inflation.....	21
7 Economic Outlook and Risks.....	22
7.1 Economic Outlook.....	22
7.2 Inflation Outlook.....	23
7.3 Risks.....	24
8 Conclusion.....	25

List of Figures

Figure 1: Evolution of the 7-day Interbank Money Market Rate.....	3
Figure 2: Term structure of Yields on Government Securities.....	4
Figure 3: Lending Rates by Sector	7
Figure 4: Annual Growth in Private Sector Credit	8
Figure 5: Contributions to Annual M3 growth.....	9
Figure 6: Merchandise Trade Balance.....	17
Figure 7: Overall Balance and Components.....	17
Figure 8: Stock of reserves.....	18
Figure 9: Exchange Rates Developments.....	19
Figure 10: Commodity price developments	21
Figure 11: Annual Inflation Developments.....	22
Figure 12: Core Inflation forecast.....	24

List of Tables

Table 1: Yields on T-bills and T-bonds.....	5
Table 2: Secondary Market Activity for T-Bills.....	5
Table 3: Secondary Market Activity for T-Bonds	6
Table 4: Sectoral Developments in Private Sector Credit.....	8
Table 5: Global Economic Performance and Outlook.....	12
Table 6: GDP Growth Rates.....	13
Table 7: Fiscal performance in FY 2015/16 (Shs. Billions).....	14
Table 8: Indicators of Public Debt Stock.....	15
Table 9: Domestic Debt Risk Indicators	15

Acronyms and Abbreviations

AEs	Advanced Economies
BoP	Balance of Payments
BoU	Bank of Uganda
CA	Current Account
CAD	Current Account deficit
CBR	Central Bank Rate
CIC	Currency in Circulation
CPI	Consumer Price Index
EFU	Energy, Fuel and Utilities
EMDEs	Emerging Market and Developing Economies
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IFEM	Interbank Foreign Exchange Market
IMF	International Monetary Fund
M-o-M	Month-on-Month
NDP	National Development Plan
NEER	Nominal Effective Exchange Rate
NPL	Non- Performing Loans
OPEC	Organization of Petroleum Exporting Countries
PDMF	Public Debt Management Framework
PPs	Percentage Points
PSC	Private Sector Credit
PSI	Policy Support Instrument
Q	Quarter
q-o-q	Quarter on Quarter
REER	Real Effective Exchange Rate
REPOs	Repurchase Agreements
SMEs	Small and Medium Enterprises
SSA	Sub- Saharan Africa
T-Bills	Treasury bills
T-Bonds	Treasury bonds
UK	United Kingdom
US	United States
USD	United States Dollar
WAI	Weighted Average Interest rate
Y-o-Y	Year-on-Year

Executive Summary

Global financial markets have stabilized somewhat since the beginning of 2016. Monetary policy easing in Japan and the Euro Area worked to lessen pressures arising from the normalization of the US monetary policy, through provision of additional funding opportunities. However following the outcome of the UK referendum, equity prices declined worldwide, renewing volatility in global financial markets. Although the volatility in the global financial markets has subsided following the Bank of England's proactive monetary policy and smooth political transition in mid-July 2016, equity valuations for UK and European banks remained lower than before. Additionally, yields on safe assets have declined further on account of global risk aversion.

The interbank money market rates were relatively stable in the months of June and July 2016, evolving in line with the monetary policy stance. The 7-day money market rates declined marginally to 15.4 per cent in July 2016, from 15.7 per cent in June 2016, while the overnight weighted average interest rate (WAI) rose to 13.5 per cent in July 2016 from 11.3 per cent recorded in May 2016 and 9.9 per cent in March 2016.

On a quarterly basis, lending rates in shilling denominated loans averaged 24.1 per cent in Q2-2016 compared to 24.6 per cent in Q1-2016, while foreign currency denominated loans averaged 9.4 per cent in Q2-2016 compared to 9.99 per cent in Q1-2016. Similarly, time deposit rates were on a decline between the two quarters. Shilling and foreign currency time deposit rates declined to 12.8 and 3.9 per cent in Q2-2016 from 15.7 and 4.1 per cent in Q1-2016, respectively. However, the spread in shilling increased to 11.33 per cent from 8.9 per cent recorded in Q1-2016, while the spread in foreign currency declined to 5.5 per cent from 5.9 per cent in Q1-2016.

Recent global developments have been shaped by the outcome of Brexit referendum, which from a macroeconomic perspective implied a substantial increase in economic, political and institutional uncertainty with negative macroeconomic consequences, especially in the Euro area. Indeed the outcome of the vote surprised the global financial markets, marking materialization of an important downside risk for the global economy. Global growth slowed to 3.1 per cent in 2015, and taking into account the likely impact of Brexit, prospects for 2016 and 2017 have been downgraded to 3.1 and 3.4 per cent, respectively. The outlook worsens for Advanced Economies (AEs) – where growth has been revised downwards to 1.8 per cent in 2016 and 2017. However, it remains broadly unchanged for Emerging Market and Developing Economies (EMDEs) at 4.1 and 4.6 per cent in 2016 and 2017, respectively.

The Ugandan economy has continued to grow, but at a moderate pace. Preliminary data for FY 2015/16 show that GDP expanded by 4.6 per cent in real terms and by 11.6 per cent in nominal terms. The 4.6 per cent real GDP growth was slightly lower than the 5.0 per cent recorded in 2014/15, but it is in line with the average of 4.6 per cent in the last four years. The moderation in growth is largely attributed to uncertainty related to the recent electioneering, weak external demand, including sluggish growth in our major trading partners, the crisis in South Sudan as well as persistently soft commodity prices, which have affected exports.

Reflecting the slowdown in economic activity, growth in private sector credit (PSC), a leading indicator of the financial sector's contribution to economic activity, continued to slow down in Q2-2016. The slowdown in growth in PSC is driven largely by provisioning for bad loans, which has heightened risk aversion in banks and relatively weak economic activity. In nominal terms, PSC growth declined from 11.6 per cent in Q1-2016 to 7.0 per cent in Q2-2016.

Preliminary fiscal data estimates for FY 2015/16 indicate that the fiscal deficit amounted to Shs. 4,019.3 billion, which was also lower than programmed by Shs. 1,362.7. The deficit was financed majorly from external sources, amounting to Shs. 2,458.5 billion while domestic financing amounted to Shs. 2,078.7 billion. Domestic financing included a drawdown on savings amounting to Shs. 606.0 billion and net issuance of Government securities of Shs. 1,350.0 billion.

During the Q2- 2016, the current account deficit (CAD) declined from USD 482 million to USD 260 million on account of improvements in all sub-accounts, with the exception of the Merchandise trade balance. The primary income deficit improved by over 36 per cent to a deficit of USD 212 million, whereas the services account deficit improved by 34 per cent to USD 151 million. The secondary income account (current transfers) improved by 17 per cent to USD 370 million.

The depreciation pressures which peaked in September 2015, with the Shilling depreciating 40 per cent y-o-y against the USD to an average mid-rate of Shs. 3,695.25 per USD, have since eased. In July 2016, the Shilling was relatively stable, depreciating slightly by 0.3 per cent m-o-m and by 0.6 per cent y-o-y to an average mid-rate of Shs. 3,375.6 per USD. The relative stability was largely because of subdued demand for imports and stronger inflows from offshore players.

Global inflation remains subdued, particularly in AEs, in part driven by low commodity prices and subdued global demand. In June 2016, average inflation in key AEs rose to 0.5 per cent from 0.2 per cent in May 2016, with most of the increase coming from the UK on account of higher prices for services such as restaurants and hotels. In the WEO update for July 2016, inflation in AEs is projected to

average 0.7 per cent, and increase to 1.6 per cent in 2017, which remains below the respective central banks medium-term targets.

Global commodity prices declined in 2015 and are projected to remain soft in 2016, reflecting soft global demand amidst abundant supplies. Crude oil prices which averaged USD 50.8 per barrel in 2015 are now forecast to decline to USD 42.9 per barrel in 2016 but rise to USD 50 per barrel in 2017. The rise in oil prices to USD 47.7 per barrel in June 2016 was mainly due to concerns regarding the UK referendum results and production disruptions mainly in Nigeria and Canada. However, the Organization of Petroleum Exporting Countries (OPEC) continues to maintain high production levels.

The Consumer Price Index (CPI) data for July 2016 indicates that domestic cost pressures remain relatively subdued. All components of inflation save for food crops inflation, declined in July 2016. Annual headline and core inflation declined to 5.1 and 5.7 per cent from 5.9 and 6.8 per cent, respectively in June 2016. Similarly, annual Energy Fuel and Utilities (EFU) inflation also declined from 6.6 per cent to 2.1 per cent, and so was other goods, services and non-food inflation, which declined to 5.8, 5.5 and 5.1 per cent, from 7.4, 6.1 and 6.4 per cent, respectively. Annual Food crops inflation however rose to 3.5 per cent from minus 1.3 per cent, largely driven by increases in prices of food crops and related items due to adverse weather conditions.

Presently, the Bank of Uganda judges that the risks to the projected path for inflation are roughly on the downside and inflation is projected to return to the target band slightly faster than previously assessed. Therefore, Bank of Uganda considered it appropriate to, further, ease the monetary policy to support recovery of economic activity. The CBR was reduced to 14 per cent. The band on the CBR was maintained at +/-3 PPs and the margin on the rediscount rate at 4.0 PPs on the CBR. The rediscount rate and the bank rate are therefore 18 per cent and 19 per cent, respectively.

1 Reflections of Monetary Policy in the Previous Period

1.1 Monetary Policy Stance

Bank of Uganda (BoU) eased the monetary policy stance further in June 2016, reducing the Central Bank Rate (CBR) by 1 percentage point (PP) to 15.0 per cent. This was warranted by the projected inflation trajectory which indicated that the inflation outlook had softened somewhat, and the risks to the outlook were tilted to the downside. There were also indications of softening domestic demand in part driven by the lagged effects of the tight monetary policy stance and a weak external environment. In June 2016, the forecast for core inflation indicated that it would converge around BoU's medium term target of 5.0 per cent by Q1- 2017.

Although the inflation outlook had improved when compared to previous forecasts, upside risks to this outlook persist, mainly from the future path of the exchange rate and the possibility of an increase in food prices in H2-2016. Nonetheless, given the weak domestic demand, weaker global conditions and lower inflation expectations, it was appropriate for monetary policy to be stimulatory to support the economic activity that was showing signs of slackening. In particular, both the objective of keeping inflation close to target and the consideration relating to capacity utilization in the economy implied that a cautious easing of monetary policy was warranted. Therefore, BoU reduced the CBR by 1.0 PP to 15 per cent. The band on the CBR was maintained at +/-3 PPs and the margin on the Rediscount Rate at 4 PPs on the CBR. The Rediscount Rate and the Bank Rate were therefore set at 19 per cent and 20 per cent, respectively.

1.2 Monetary Policy Implementation

BoU continued to use Repurchase Agreement (REPOs), reverse REPOs and sales of government securities in the secondary market to align liquidity conditions in the domestic money market with the desired monetary policy stance. The net impact of the REPO/reverse REPO instrument in June to July 2016 was an injection of Shs. 235 billion, with the outstanding stock of REPOs as at the end July 2016 being Shs. 419 billion.

2 Money and Financial Markets Developments

2.1 Global Financial Markets

A well-functioning money or financial market is a crucial component of the financial system as it contributes to market efficiency and discipline, impacts on financial stability and on financing conditions in the economy at large. It plays an important part in information aggregation and price discovery, and is an initial channel of monetary policy transmission. However, financial markets are very susceptible to sudden changes in investor sentiments, particularly in an open economy, where any sudden changes in investor sentiments regarding global and domestic conditions generate financial market volatility.

Global financial markets have stabilized somewhat since the beginning of 2016. Monetary policy easing in Japan and the Euro Area worked to lessen pressures arising from the normalization of the US monetary policy, through provision of additional funding opportunities. However following the outcome of the UK referendum, equity prices immediately declined worldwide, renewing volatility in global financial markets. Although volatility in the global financial markets has subsided following the Bank of England's proactive monetary policy and smooth political transition in mid-July 2016, equity valuations for UK and European banks remained lower than before. Additionally, yields on safe assets have declined further on account of global risk aversion. In response to the referendum result, major central banks, particularly the European Central Bank (ECB) and the US Fed, indicated readiness to provide both domestic currency and foreign exchange liquidity, which supported investor confidence leading to relative stabilization of market conditions within two weeks of the vote result.

In Emerging Markets and Developing Economies (EMDEs), asset prices and exchange rate movements have generally been contained following the Brexit referendum vote. However, capital flows remain vulnerable to sudden changes in investors' risk appetite. Whilst the Brexit poses an increase in uncertainty, its effects are still unclear. Geopolitical tensions, domestic strife, particularly in the Middle East have added to the global uncertainty.

Following the Brexit, there was a general decline in 10-year government yields particularly for AEs. Yields in the US, UK, Euro Area and Japan fell to 1.6, 1.1, 0.03 and -0.2 per cent in the quarter to July 2016 from 1.7, 1.4, 0.1 and -0.1 per cent, respectively, in the quarter to June 2016. The declines in yields reflected the compacted term premia, in addition to a gradual pace of monetary

policy normalization. The effect of the Brexit on the yields in EMDEs has so far been largely muted. Yields in India, China, Brazil, South Africa and Russia declined only marginally from 7.5, 3.0, 12.9, 9.1 and 8.9 per cent in Q2-2016 to 7.4, 2.9, 12.4, 9.0 and 8.7 per cent, respectively in the quarter to July 2016.

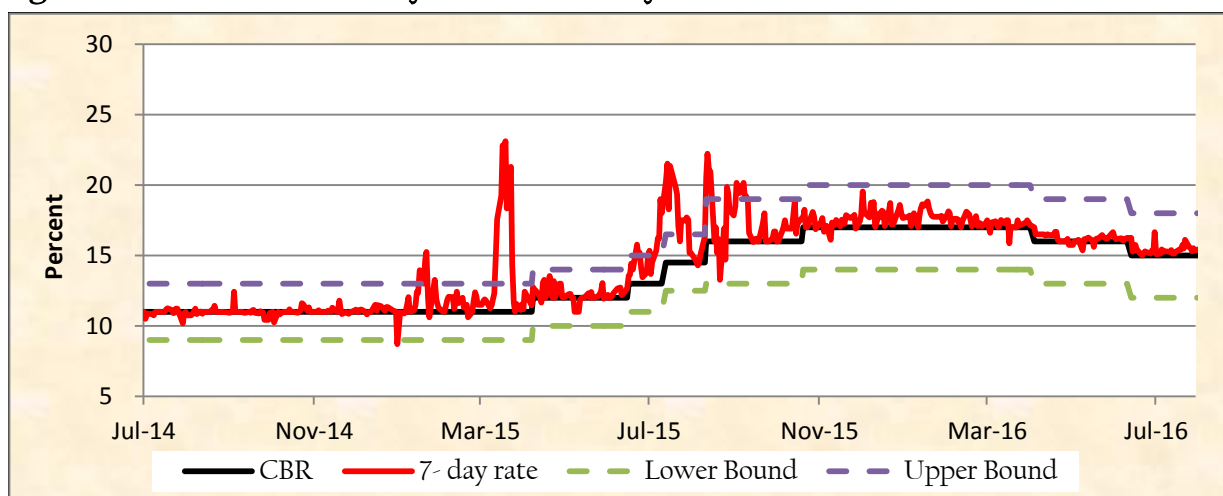
In the currencies market, while the British Pound depreciated to 0.72 per USD in the quarter to July compared to 0.70 per USD in the quarter to June 2016, the Euro was relatively stable over the 4 months of April to July 2016 at 0.89 per USD. The Japanese Yen appreciated to 106.1/USD in the quarter to July 2016, from 108.1/USD in quarter to June 2016. In EMDEs, the South African Rand fell to 14.9/USD in quarter to July 2016 from 15.0/USD in the quarter to June 2016. However, the Indian Rupee and Chinese Yuan depreciated to 67.2/USD and 6.6/USD in the quarter to July 2016 from 66.9/USD and 6.5/USD, respectively in the quarter to June 2016.

2.2 Domestic Financial Markets

2.2.1 Interbank Money Market

The interbank money market rates were relatively stable in the months of June and July 2016, evolving in line with the monetary policy stance, despite the structural liquidity overhang. The 7-day money market rates declined marginally to 15.4 per cent in July 2016, from 15.7 per cent in June 2016, while the overnight weighted average interest rate (WAI) rose to 13.5 per cent in July 2016 from 11.3 per cent recorded in May 2016 and 9.9 per cent in March 2016. Developments in the 7-day interbank money market rate and the CBR are shown in **Figure 1**.

Figure 1. Evolution of the 7-day Interbank Money Market Rate



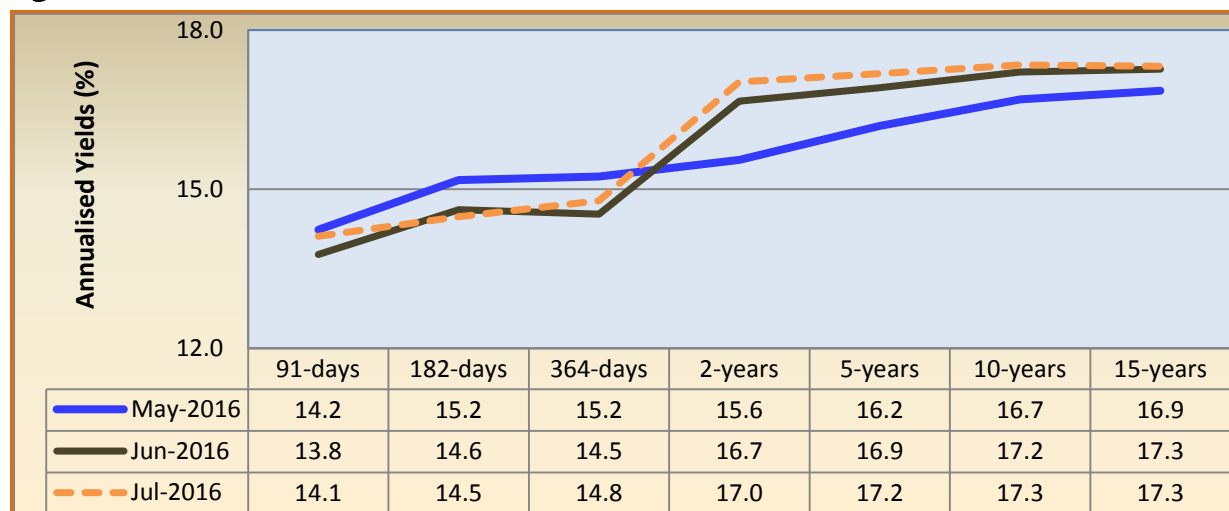
Source: Bank of Uganda

The volume of transactions in the interbank money market rose slightly to Shs 3,817.1 in the two months to July 2016 compared to Shs 3,759.8 in the two months to May 2016. The overnight tenure contributed 75 per cent share of the total money market volume, compared to the 7-day tenure which contributed 23 per cent of total trades in the two months under review. The 7-day money market rates declined steadily in line with the monetary policy stance, from an average of 16.3 per cent in May 2016 to 15.7 per cent and 15.7 per cent recorded in June and July 2016, respectively while the overnight rate rose from 11.3 per cent in May 2016 to 13.5 per cent in the two months under review.

2.2.2 Primary Market for Treasury Securities

In the quarter to July 2016, BoU conducted six Treasury Bills (T-bills) worth Shs. 1,195 billion and three Treasury bonds (T-bonds) worth Shs. 625 billion compared to Shs. 1,285 billion and Shs. 560 billion, respectively offered in the quarter to April 2016. After a steady downward trend since January 2016, yields on T-bill rates rose in June and July 2016 while yields on T-bonds registered declines. There were under subscriptions in the 91-day and 182-day papers while there was more appetite for the 364-day paper and treasury bonds. **Figure 2** shows the term structure of yields on Government securities. The yield curve flattens over the horizon of the longer dated bonds, implying that prices are likely to remain stable in the long run.

Figure 2. Term structure of Yields on Government Securities



Source: Bank of Uganda

The 91-day, 182-day and 365-day T-bill rates fell to 14.1, 14.5 and 14.8 per cent, in July 2016 from 14.2, 15.2 and 15.2 per cent in May 2016, respectively. On the other hand, the 2-year, 5-year and 10-year T-bond rates rose to 17.0, 17.2 and 17.3 per cent in July 2016 from 15.6, 16.2 and 17.2 per cent, respectively in May 2016. The 15-year T-bond rate remained relatively stable at 17.0 per cent, as shown in **Table 1**.

Table 1. Yields on T-bills and T-bonds

	Feb-16	Mar-16	Apr-16	May-16	Jun-16	Jul-16
Government securities						
91-day T-bill	19.9	16.6	14.7	14.2	13.8	14.1
182-day T-bill	22.2	17.8	15.4	15.2	14.6	14.5
364-day T-bill	22.6	16.8	15.4	15.2	14.5	14.8
2-year T-bond	22.3	17.3	15.8	15.6	16.7	17.0
5-year T-bond	20.3	17.3	16.4	16.2	16.9	17.2
10-year T-bond	19.0	17.5	16.7	16.7	17.2	17.3
15-year T-bond	18.7	17.5	16.8	16.9	17.3	17.3

Source. Bank of Uganda

2.2.3 Secondary Market for Treasury Securities

In the secondary market, the yields on the 182-day and 364-day Treasury bills rose to respective averages of 16.7 and 16.6 per cent in the two months to July 2016 from averages of 16.1 per cent and 15.9 per cent recorded in the previous months. The 91-day Treasury bill yield on the other hand fell from 16.7 per cent in May 2016 to 15.8 per cent in July 2016. The total volume of trades in T-bills amounted to Shs 123.7 billion compared to Shs 276.6 billion recorded in the two months to May 2016. A summary of secondary market activity for T-bills over the two months to July 2016 is shown in **Table 2**.

Table 2. Secondary Market Activity for T-Bills

	91-day		182-day		364-day	
	Bid	Offer	Bid	Offer	Bid	Offer
Minimum	14.22	14.11	15.29	15.18	15.36	15.24
Maximum	15.24	15.12	16.28	16.16	17.19	17.06
Average (simple)	14.75	14.64	15.68	15.56	16.50	16.38
	Total trading activity`					
Outright sales (billions)	2.1		2.5		119.0	
Average discount rate	14.50		15.02		14.35	
Average yield-to-maturity	15.79		16.74		16.62	

Source. Bank of Uganda

In the secondary market as shown in the **Table 3**, yields on all long term government securities rose in the two months to July 2016. The 2-year, 5-year, 10-year, 15-year Treasury bonds rose to respective average rates of 16.2, 16.0, 17.3, 17.8 and 16.9 per cent from 15.9, 16.0, 16.4, 16.6 and

15.9 per cent in the previous months. The volume of secondary market trades in T-bonds fell to Shs. 250.3 billion in the two months to July 2016 from Shs. 551.9 billion traded during the previous months.

Table 3. Secondary Market Activity for T-Bonds

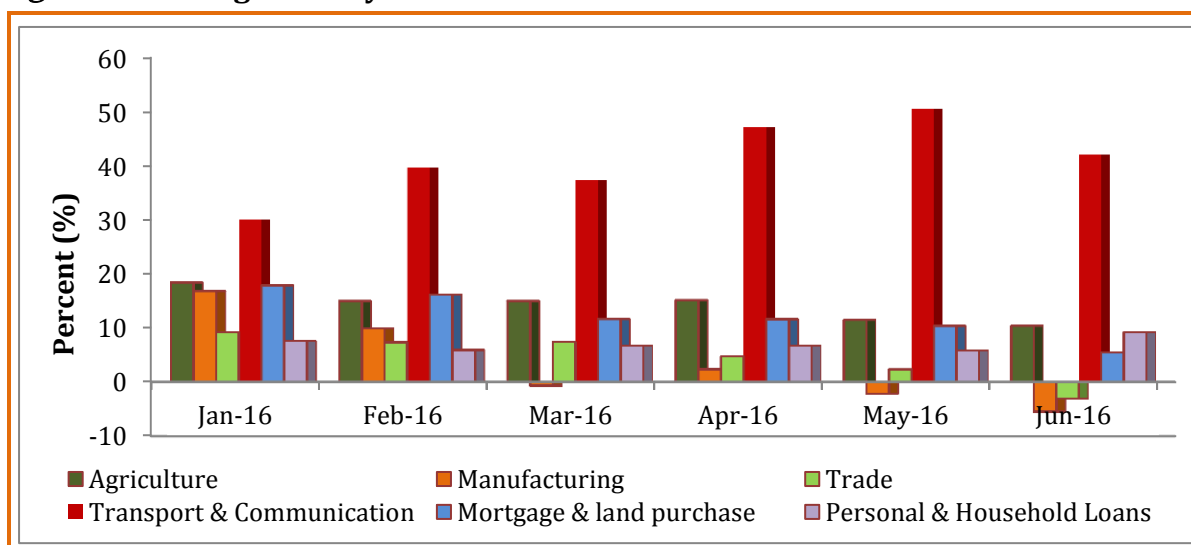
	2-year		3-year		5-year		10-year		15-year	
	Bid	Offer	Bid	Offer	Bid	Offer	Bid	Offer	Bid	Offer
Minimum	15.85	15.75	16.20	16.10	15.56	15.46	16.90	16.80	17.00	16.90
Maximum	17.30	17.20	17.45	17.35	17.50	17.40	17.65	17.55	17.75	17.65
Average (simple)	16.89	16.79	17.03	16.93	17.10	17.00	17.33	17.23	17.36	17.26
	Total trading activity									
Outright sales (billions)	13.0		85.1		98.0		1.0		53.2	
Average yield-to-maturity	16.22		16.25		17.30		17.75		16.85	

Source: Bank of Uganda

2.2.4 Lending and deposit interest rates

On a quarterly basis, lending rates in shilling denominated loans averaged 24.1 per cent in Q2-2016 compared to 24.6 per cent in Q1-2016, while foreign currency denominated loans averaged 9.4 per cent, down from 9.99 per cent. Similarly, time deposit rates were on a decline between the two quarters. Shilling and foreign currency time deposit rates declined to 12.8 and 3.9 per cent in Q2-2016 from 15.7 and 4.1 per cent in Q1-2016, respectively. However, the spread in shilling increased to 11.33 per cent from 8.9 per cent recorded in Q1-2016, while the spread in foreign currency declined to 5.5 per cent from 5.9 per cent in Q1-2016. Lending rates declined across the sectors except for trade, personal and household loans and mortgage & land purchase, which rose from 23.2, 24.8 and 24.6 per cent in Q1-2016 to 23.8, 25.0 and 25.7 per cent in Q2-2016. **Figure 3** shows developments in commercial bank lending rates.

Figure 3: Lending Rates by Sector



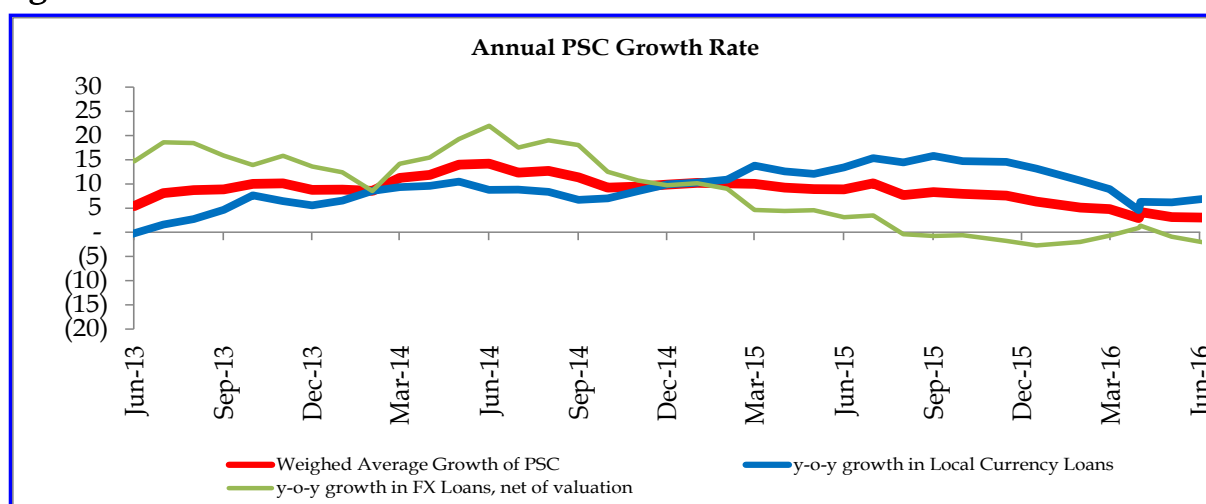
Source: Bank of Uganda

Notwithstanding the marginal reductions, lending rates remain elevated, in part reflecting provisioning for bad debt, lagged impact of the tight monetary policy stance and structural rigidities in the financial sector, including the high cost of doing business. Indeed, Non-Performing Loans (NPLs) as a ratio of gross loans increased from 6.9 per cent in Q1-2016 to 7.4 per cent in Q2-2016. The agriculture sector recorded the largest increase in its total bad loans mainly due to foreign currency denominated NPLs. Further increases in NPLs could heighten the risk aversion of commercial banks and further constrain credit growth.

2.2.5 Private Sector Credit

Growth in private sector credit (PSC), a leading indicator of the financial sector's contribution to economic activity, continued to slow down in Q2-2016. The slowdown in growth in PSC is driven largely by provisioning for bad loans, which has heightened risk aversion in banks and relatively weak economic activity. In nominal terms, PSC growth declined from 11.6 per cent in Q1-2016 to 7.0 per cent in Q2-2016. The average annual growth in shilling value of forex PSC continued to decline to 7.9 per cent in the quarter to June 2016, compared to 16.5 per cent in the quarter to March 2016, while in US dollar terms, the annual growth averaged minus 0.3 per cent in the quarter to June. Similarly, growth in Shilling loans declined to 6.5 per cent from 8.1 per cent in the previous quarter and 12.7 per cent in the quarter to June 2015. After accounting for valuation changes, credit growth in the first half of 2016 averaged 3.9 per cent compared to 9.6 per cent in the same period of 2015. Developments in private sector credit are shown in **Figure 4**.

Figure 4. Annual Growth in Private Sector Credit



Source: Bank of Uganda

In terms of sectoral distribution, building & construction, trade, manufacturing and personal & household loans continued to account for the bulk of PSC, constituting more than 70 per cent of the total stock. During the period under review, lending to almost all sectors slowed, picking only for water & electricity, and personal and household loans. In addition, lending to the business services sector that is largely comprised of Small and Medium Enterprises (SMEs), perceived to be more risky by commercial banks continued to drop. Sectoral developments in private sector credit are shown in **Table 4**.

Table 4. Sectoral Developments in Private Sector Credit

	Annual Growth Rate						Average
	Jan-16	Feb-16	Mar-16	Apr-16	May-16	Jun-16	
Agriculture	18.40	14.99	14.99	15.16	11.49	10.41	10.31
Mining and Quarrying	51.20	65.45	66.68	47.80	48.31	39.40	0.62
Manufacturing	16.82	9.94	-0.67	2.36	-2.18	-5.47	13.98
Trade	9.18	7.35	7.40	4.79	2.35	-3.10	18.97
Transport and Communication	30.06	39.67	37.30	47.16	50.53	42.07	7.02
Electricity and Water	5.15	-2.62	10.68	-0.17	3.63	24.53	1.98
Building, Mortgage, Construction and Real Estate	17.87	16.15	11.66	11.63	10.40	5.47	22.79
Business Services	7.80	-6.12	-15.71	-18.06	-10.64	-15.77	3.83
Community, Social & Other Services	5.64	6.96	12.88	10.42	11.18	7.25	3.38
Personal Loans and Household Loans	7.58	5.93	6.75	6.71	5.84	9.22	15.77
Other Services	12.98	2.67	10.93	28.47	22.92	0.19	1.35
Total	13.90	11.20	8.69	9.02	7.59	4.41	100.00

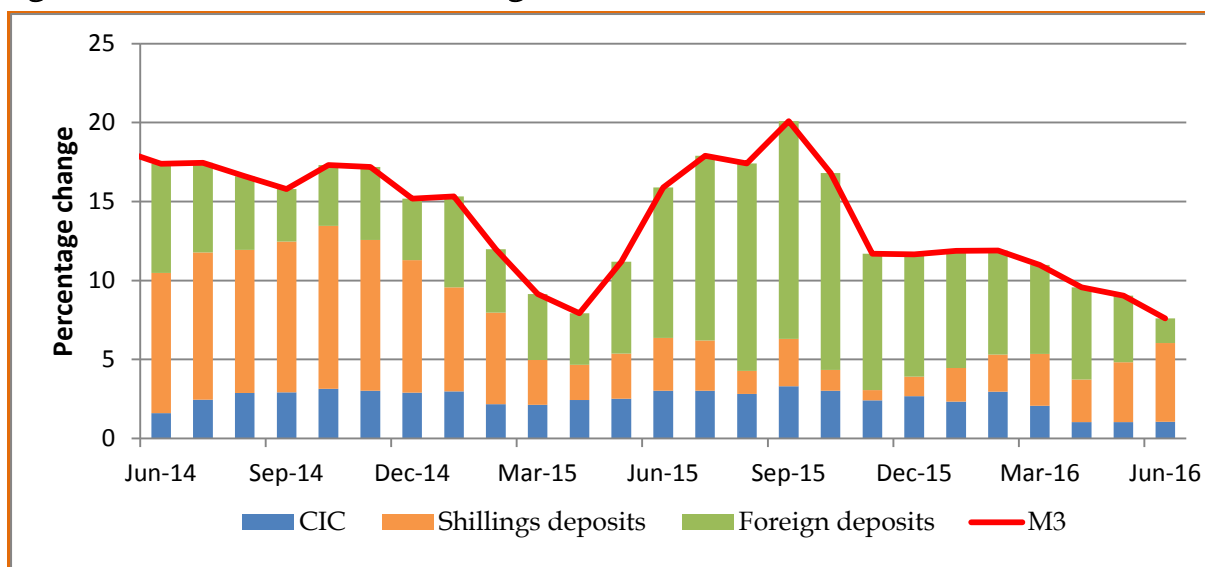
Source: Bank of Uganda

2.2.6 Other Monetary Aggregates

Growth in monetary aggregates remained subdued in Q2-2016 partly on account of the lagged effect of the tight monetary policy stance. Annual growth in M3 averaged 8.7 per cent in Q2-2016 compared to an average annual growth rate of 11.6 per cent in Q1-2016 mainly due to slower growth in foreign currency deposits. Growth in M1 averaged 4.9 per cent in the quarter to June 2016, which was lower than the 7.1 per cent recorded in the quarter to March 2016, while growth in M2 was stable at 7.1 per cent over the two quarters. Overall, growth in monetary aggregates was lower in the first half of 2016 compared to the same period in the previous year, pointing to constrained aggregate demand.

Developments in M1 and M2 were largely due to decreases in base money which incorporates Currency in Circulation (CIC) and reserves. Base money declined to 9.0 per cent in Q2-2016 from 14.2 per cent in Q1-2016. M-o-m, base money rose to 14.8 per cent in June 2016 from 8.9 per cent in May 2016. Forex deposits also grew at a slower pace in Q2-2016, averaging 12.8 per cent y-o-y compared to 22.5 per cent in Q1-2016. On the other hand, demand deposits and time & savings deposit grew much faster in Q2-2016, at 4.0 and 10.4 per cent, from 2.1 and 7.3 per cent in Q1-2016, respectively. Developments in monetary aggregates are shown in **Figure 5**.

Figure 5. Contributions to Annual M3 growth



Source: Bank of Uganda

3 Economic Activity

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

3.1 Global Economic Activity

On June 23 2016, the United Kingdom (UK) voted in a referendum to leave the European Union (EU). The Brexit vote, from a macroeconomic perspective, implied a substantial increase in economic, political and institutional uncertainty with negative macroeconomic consequences, especially in the Euro area. Indeed the outcome of the vote surprised the global financial markets, marking materialization of an important downside risk for the global economy. Before the Brexit vote, growth in most Advanced Economies (AEs) remained lacklustre, with low potential growth and a gradual closing of output gaps. Prospects remained diverse across EMDEs with some improvement in a number of countries, particularly Brazil and Russia, pointing to a modest improvement in 2017 global growth prospects.

Global growth slowed to 3.1 per cent in 2015 from 3.4 per cent in 2014, and taking into account the likely impact of Brexit, prospects for 2016 and 2017 have been downgraded by 0.1 percentage point (pp) to 3.1 and 3.4 per cent, respectively. The outlook worsens for AEs – where growth has been revised downwards by 0.1 pp and by 0.2 PPs to 1.8 per cent in 2016 and 2017, on account of the Brexit. However, it remains broadly unchanged for EMDEs at 4.1 and 4.6 per cent in 2016 and 2017, respectively.

While growth in the United Kingdom (U.K) in H1 2016 was slightly stronger than expected, the uncertainty surrounding the Brexit referendum outcome is projected to significantly weaken domestic demand, with growth revised downwards to 1.7 per cent and to 1.3 per cent in 2016 and 2017, respectively from 1.9 per cent and 2.2 per cent in 2017. Growth in the US was revised downwards by 0.2 PPs to 2.2 per cent in 2016 due to weaker than expected first quarter growth. US growth is however, expected to rebound to 2.5 per cent in 2017 on account of fading headwinds

from a strong U.S. dollar and lower energy sector investment, going forward. Growth in the Euro Area in 2016 was projected slightly higher at 1.6 per cent, given the outcomes in H1 2016 on the back of strengthening domestic demand among member countries. However, in light of increased uncertainty on consumer and business confidence due to the Brexit vote, growth in 2017 is now forecast at 1.4 per cent. Growth projections in France, Italy and Spain were downgraded to 1.5, 0.9 and 2.6 per cent, respectively in 2016 and to 1.2, 1.0 and 2.1 per cent, respectively in 2017.

Growth in EMDEs continues to be plagued by the slow growth in AEs, the persistently low commodity prices, weak global trade and capital flows. Growth in EMDEs which slowed down to 4.0 in 2015 is expected to pick up to 4.1 and 4.6 per cent in 2016 and 2017, respectively. Real activity indicators were stronger in China on account of the policy stimulus, which included cutting benchmark lending rates five times in 2015, expansionary fiscal policy, and accelerated credit growth. China's growth outlook is broadly unchanged at 6.6 and 6.2 per cent in 2016 and 2017, respectively. The direct impact of the U.K referendum on China will likely be limited in light of economy's low trade and financial exposure to the U.K and the authority's readiness to respond to achieve their growth target range. However, should growth in the EU be affected significantly, the adverse impact on China could materialize.

Consumer and business confidence appear to have bottomed out in Brazil. Consequently, the 2016 recession is now projected to be less severe, with a return to positive growth in 2017. However, the Zika virus in Latin America and Caribbean region is bound to adversely affect growth. In Russia, a rebound in oil prices is providing some relief, but prospects of a strong recovery are subdued given long-standing structural bottlenecks and the impact of sanctions on productivity and investment. In India, economic activity remains buoyant, but the growth forecast for 2016 -17 was trimmed down slightly, reflecting a more sluggish investment recovery.

Growth in sub-Saharan Africa (SSA) has been revised down substantially by 1.4 PPs to 1.6 per cent in 2016 and by 0.7 pp to 3.3 per cent in 2017. The down grade reflects challenging macroeconomic conditions in its largest economies, which are adjusting to lower commodity revenues. Growth in Nigeria is projected to contract to minus 1.8 per cent in 2016, as the economy adjusts to foreign currency shortages as a result of lower oil receipts, low power generation and weak investor confidence. GDP growth in South Africa is projected to remain flat in 2016, with only a modest recovery in 2017. Climate related factors such as the drought in East and Southern Africa is also expected to adversely affect SSA growth. Global growth projections are presented in **Table 5**.

Table 5. Global Economic Performance and Outlook

	Outturn	Projections	
	2015	2016	2017
World	3.1	3.1	3.4
Advanced Economies	1.9	1.8	1.8
United States	2.4	2.2	2.5
Euro Area	1.7	1.6	1.4
Japan	0.5	0.3	0.1
United Kingdom	2.2	1.7	1.3
Emerging Market and Developing Economies	4.0	4.1	4.6
Russia	-3.7	-1.2	1.0
Brazil	-3.8	-3.3	0.5
China	6.9	6.6	6.2
India	7.6	7.4	7.4
Sub-Saharan Africa	3.3	1.6	3.3
Nigeria	2.7	-1.8	1.1
South Africa	1.3	0.1	1.0

Source: IMF, WEO July 2016

3.2 Domestic Economic Activity

The Ugandan economy has continued to grow, but at a moderate pace. Preliminary data for FY 2015/16 show that GDP expanded by 4.6 per cent in real terms and by 11.6 per cent in nominal terms (**Table 6**). The 4.6 per cent real GDP growth was slightly lower than the 5.0 per cent recorded in 2014/15, but it is in line with the average of 4.6 per cent in the last four years. The moderation in growth is largely attributed to uncertainty related to the recent electioneering, weak international economic environment, including sluggish growth in our major trading partners and the crisis in South Sudan, persistently soft commodity prices, which have affected exports.

Supply side constraints, including: a slowdown of labour force growth, which had been a major contributor to growth in the 2000s; slowing productivity growth as most of the labour force is absorbed in micro-enterprises; increased investment in sectors with low returns such as real estate; and the fact that investment in the oil sector, which has comprised about half of Foreign Direct Investment (FDI), has not yet yielded any significant contribution to GDP, have characterized the economy in recent years. Real GDP growth has been mediocre since 2008/09, averaging about 5.0 per cent, so that the performance in FY 2015/16 was not much worse than the recent historical average. Potential growth appears to have fallen by 1–2 PPs since the end of the 2000s.

Table 6. GDP Growth Rates

Real Growth Rates			
	Average 2011/12-2015/16	2014/15	2015/16
GDP	4.6	5.0	4.6
Traded goods	2.9	5.1	2.4
Non Traded goods	5.6	4.4	6.4
Nominal Growth Rates			
	Average 2011/12-2015/16	2014/15	2015/16
GDP	10.0	11.1	11.6
Traded goods	5.3	7.5	7.4
Non Traded goods	12.4	12.0	14.6

Source: Uganda Bureau of Statistics

4 Fiscal Policy and Developments

Fiscal policy plays a significant role, both as a stabilization tool and in influencing the short- and long-term growth prospects of an economy. In the short term, counter-cyclical fiscal expansion can help support aggregate demand and growth during downturns. On the other hand, fiscal contraction can help cool down an economy that is growing at an unsustainable pace and thus faces the risk of overheating. The fiscal stance for FY 2015/16 focused on supporting economic growth by addressing infrastructural constraints in the economy.

4.1 Government Expenditure and Revenue

Preliminary fiscal data estimates for FY 2015/16 indicate that the fiscal deficit amounted to Shs. 4,019.3 billion, which was also lower than programmed by Shs. 1,362.7. The deficit was financed majorly from external sources, amounting to Shs. 2,458.5 billion while domestic financing amounted to Shs. 2,078.7 billion. Domestic financing included a drawdown on savings amounting to Shs. 606.0 billion and net issuance of Government securities of Shs. 1,350.0 billion.

Total government expenditure and net lending amounted to Shs. 16,664.2 billion which was Shs. 1,925.8 billion lower than the programmed expenditure. The lower outturn was due to lesser than programmed development expenditure and government net lending by Shs. 1,193.7 billion and Shs. 964.5 billion, respectively, as shown in **Table 7**. The underperformance in development expenditure was mainly due to lower than programmed externally financed expenditure while net lending was lower than programmed on account of lower expenditure on the Hydro Power Projects. Conversely,

current expenditure which amounted to Shs. 9,185.0 billion was Shs. 189.0 billion higher than programmed.

Table 7. Fiscal performance in FY 2015/16 (Shs. Billions)

	<i>2013/14</i>	<i>2014/15</i>	<i>2015/16</i>	<i>Program</i>	<i>Variation</i>	<i>FY 2016/17</i>
Revenue & Grants	8,870.4	11,044.8	12,644.9	13,208.0	-563.1	15,071.0
Revenue	8,167.9	10,114.0	11,498.5	11,774.0	-248.5	13,386.0
Tax	8,031.0	9,772.9	11,059.1	11,040.0	19.1	12,585.0
Non-Tax	136.9	221.5	318.1	582.0	-263.9	674.0
Grants	702.5	930.8	1,146.4	1,461.0	-314.6	1,685.0
Expenditure &	11,682.3	14,378.7	16,664.2	18,590.0	-1,925.8	20,875.0
Current	6,706.3	7,689.3	9,185.0	8,996.0	189.0	9,656.0
Development	4,936.5	5,229.5	5,823.3	7,017.0	-1,193.7	9,087.0
Net	19.4	1,235.2	1,532.5	2,497.0	-964.5	1,782.0
Domestic arrears	20.0	224.7	123.4	80.0	43.4	110
<i>o/w External</i>	<i>1,921.5</i>	<i>2,919.8</i>	<i>2,873.7</i>	<i>2,851.8</i>	<i>22.0</i>	
Deficit (including	-2,811.9	-3,333.9	-4,019.3	5,382.0	1,362.7	-5,804.0
Financing (net)	2,811.9	3,333.9	4,019.3	5,382.0	-1,362.7	5,804.0
& of GDP	-4.1	-4.5	-4.8	-6.4	1.6	-6.2
External Financing	886.9	919.0	2,458.5	4,017.0	-1,558.5	4,969.0
Domestic	1,650.0	2,483.4	2,078.7	1,365.0	713.7	835.0
Errors & Omissions	274.9	-68.5	-517.9	0.0		

Source: Ministry of Financing, Planning and Economic Development

Total government revenue, including grants amounted to Shs. 12,644.9 billion, which was Shs. 563.1 billion lower than programmed due to under performance in both revenue and grants. Domestic revenue amounted to Shs. 11,498.5 billion, Shs. 383.8 billion lower than the programme target. Grants receipts were also lower than programmed by Shs. 314.6 billion due to an underperformance in project support grants.

In line with the National Development Plan (NDP) II, the fiscal stance for FY 2016/17 also focuses on the need to address the infrastructural constraints in the economy in order to increase economic efficiency and reduce the cost of doing business. Total government expenditures and lending is projected at Shs 20,875 billion from Shs 16,664.2 billion in FY 2015/16, while domestic revenues are projected to increase to Shs. 13,386.0 billion in FY 2016/17 from Shs. 11,498.5 billion. The increase in domestic revenues will be achieved by improving efficiency in tax administration, increasing the tax base by reducing the size of the informal sector, and increasing investment in tax collection infrastructure. The budget deficit is projected at 6.2 per cent of GDP compared to 4.8 per cent of GDP in FY 2015/16, an indication of an expansionary fiscal stance. The deficit will largely be

funded by external sources as domestic borrowing by issuance of Government securities is projected at Shs. 612 billion down from Shs. 1,384 billion in FY 2015/16.. Overall, if the budget is executed as proposed, it could crowd in private sector and spur growth.

4.2 Public Debt Stock

The provisional total public debt stock, in nominal terms, stood at Shs. 28,982.7 billion at end June 2016, which was 34.4 per cent of GDP. Total public debt stock increased by Shs. 4,648.2 billion relative to June 2015. External and domestic debt increased by 20.6 per cent and 16.8 per cent, respectively in FY 2015/16. External debt made up the bulk of the total public debt, accounting for 60.2 per cent as shown in **Table 8**.

Table 8. Indicators of Public Debt Stock

	Jun-14	Jun-15	Prov. June -16
Total Gross Public Debt	19,333.0	24,334.5	28,982.7
External Debt (US\$, Mn)	4,300.7	4,380.1	5,124.5
External Debt (Shs. Bn)	11,180.6	14,462.2	17,448.4
Domestic Debt (Nominal, Shs. Bn)	8,152.4	9,872.3	11,534.3
UShs./US\$ (eop) exchange rate	2,599.7	3,301.8	3,404.9

Source: Bank of Uganda

External debt cost and risk indicators were within the Public Debt Management Framework (PDMF) medium-term benchmarks. In contrast, most of the domestic debt cost and risk indicators remained out of line with the benchmarks, with the domestic debt stock continuing to exhibit roll over risk. Developments in domestic debt risk indicators are shown in **Table 9**.

Table 9. Domestic Debt Risk Indicators

	PDMF	Jun-15	Jun-16
Stock/PSC (at nominal value)	<75%	90.0	100.9
% maturing in 1 year	<40%	46.7	44.5
% maturing in any year after year 1	< 20%	15.6% Yr2 & 5.6 in Yr 3	11.3% Yr2 & 7.8 in Yr 3
bonds/bills (at face value)	70/30	66/34	66/34
Avg Time to Maturity	>3Year	3.0	3.3

Source: Bank of Uganda

5 Balance of Payments and Exchange rate Developments

5.1 Balance of Payments

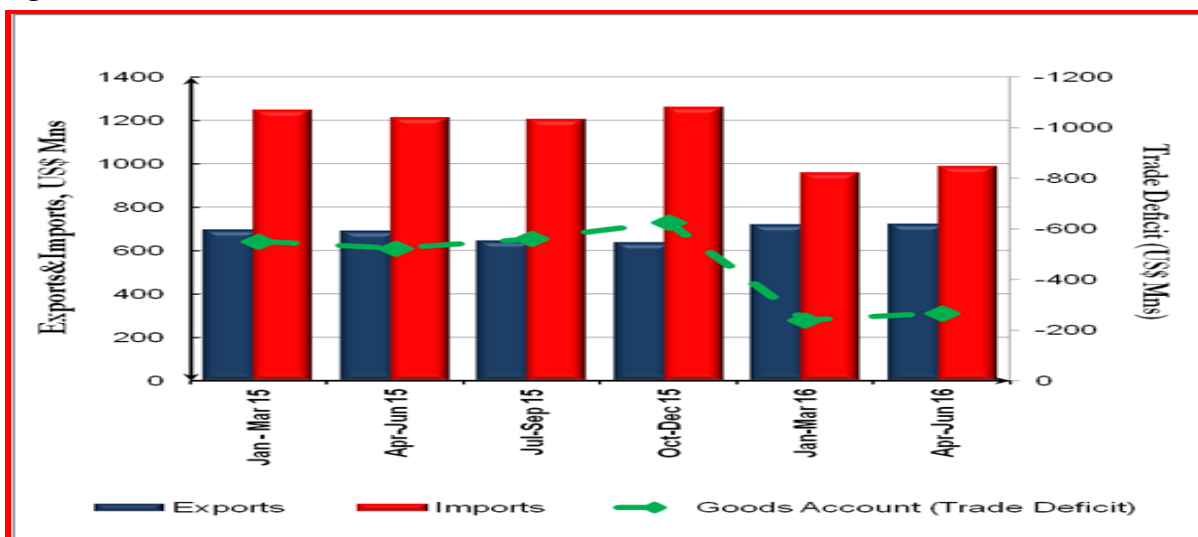
A large current account (CA) deficit usually implies an external imbalance in the economy, which in a flexible exchange rate regime might be corrected by depreciation of the exchange rate. Persistent CA deficits may, however, signal structural constraints in the economy, in which case adjustment in the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

5.1.1 Current Account Developments

During Q2- 2016, the current account deficit (CAD) declined from USD 482 million to USD 260 million on account of improvements in all sub-accounts, with the exception of the Merchandise trade balance. The primary income deficit improved by over 36 per cent to a deficit of USD 212 million, whereas the services account deficit improved by 34 per cent to USD 151 million. The secondary income account (current transfers) improved by 17 per cent to USD 370 million.

On the other hand, the merchandise trade deficit worsened by 11.4 per cent to USD 267 million mainly on account of a 5.9 per cent increase in private sector import bill, Quarter-on-quarter (q-o-q), non-oil import bill increased by 4.4 per cent to USD 770 million, which may be suggestive of a pick-up in domestic economic activity as did the oil import bill, which increased by 14.3 per cent to USD 157 million. Government imports declined by 33.5 per cent to USD 46 million, while exports remained subdued, increasing only marginally by 0.2 per cent, supported by a rise in the value of coffee exports, which rose by 6.5 per cent, q-o-q, to USD 85 million, owing to higher export volumes. Developments in merchandise trade balance are shown in **Figure 6**.

Figure 6. Merchandise Trade Balance

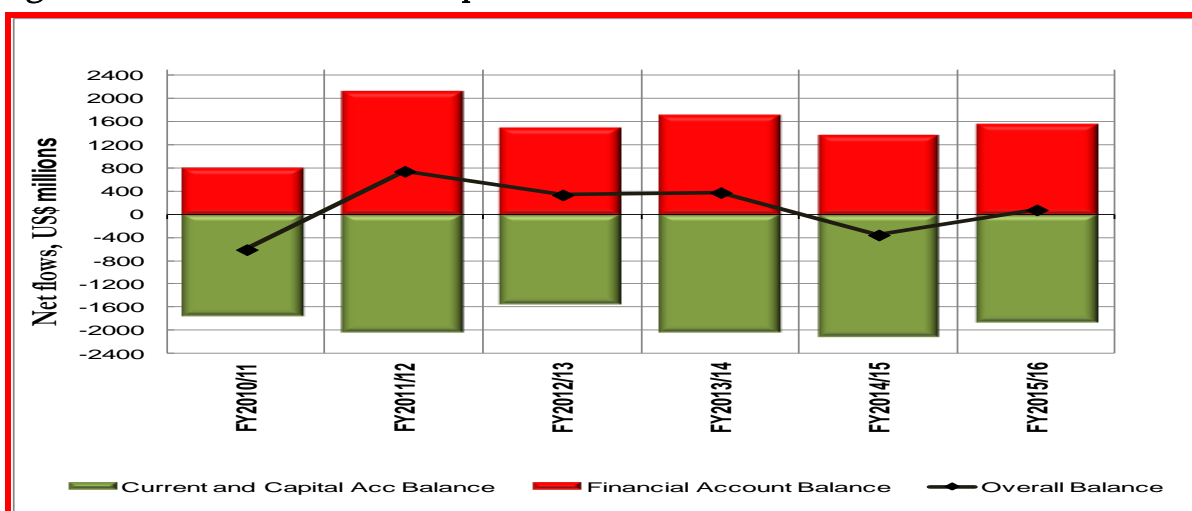


Sources: Bank of Uganda

5.1.2 Capital and Financial account

The deficits in the CAD continue to be funded by the surpluses in the Financial Account of the balance of payments (BoP). In Q2- 2016, net inflows (liabilities) through the financial account increased by 13.6 per cent, q-o-q, to USD 369 million driven by developments in portfolio investment; portfolio outflows contracted by over 50 per cent, q-o-q, to USD 20 million. As a result of a USD 62 million increase in holding of long term debt securities by non-residents, direct investment inflows increased slightly to USD 225 million, from USD 222 million and the investments inflows (that include loans, trade credits, currency and deposits), decreased by 10.8 per cent to USD 163 million.

Figure 7. Overall Balance and Components

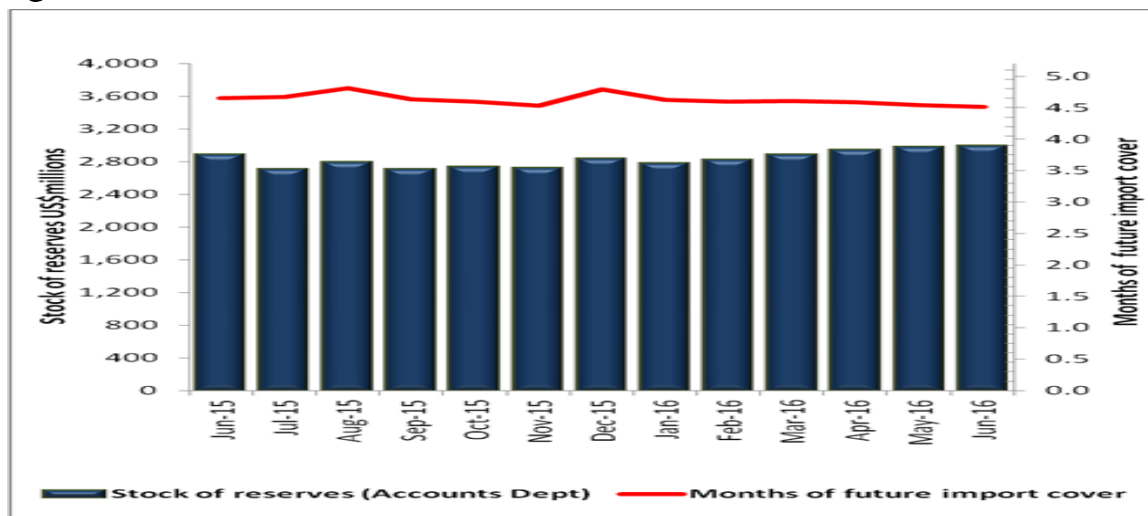


Source: Bank of Uganda

The overall balance of payments was a surplus of USD 116 million during the quarter ended June 2016, leading to a net build up in reserves of USD 114 million. Developments in the overall BoP is shown in **Figure 7**.

The stock of reserves at the end of June 2016 was USD 2.94 billion, which is equivalent to 4.3 months of future imports of goods & services. Developments in the stock of Reserves are shown in **Figure 8**. In the short term, the current account deficit is likely to widen due to increases in government and private sector imports. Exports are likely to decline as a result of prolonged drought and the unrest in South Sudan, one of our major export destinations.

Figure 8. Stock of reserves



Source: Bank of Uganda

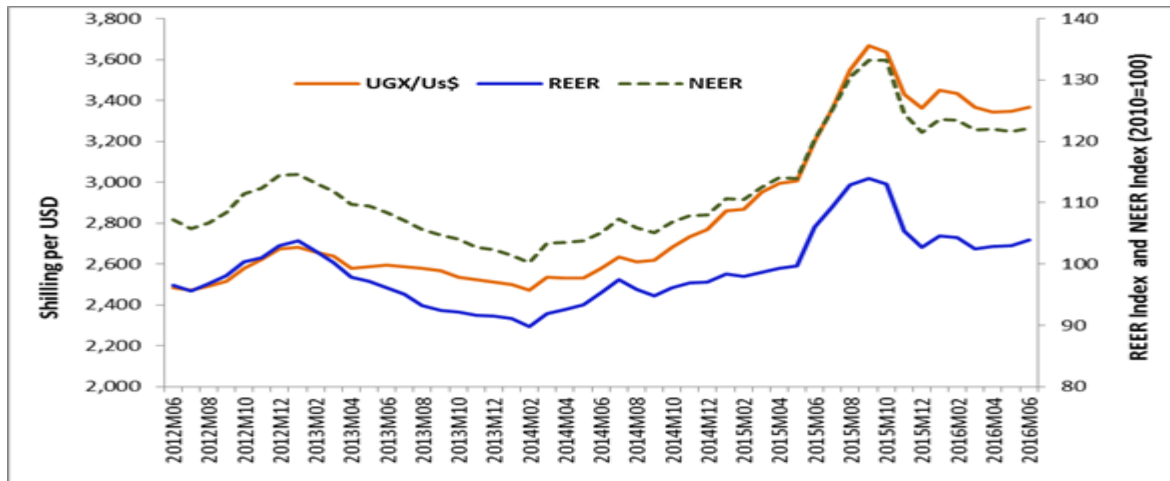
5.2 Exchange Rate Developments

The depreciation pressures that peaked in September 2015, with the Shilling depreciating 40 per cent y-o-y against the USD to an average mid-rate of Shs. 3,695.25 per USD, have since eased. In July 2016, the Shilling was relatively stable, depreciating slightly by 0.3 per cent m-o-m and by 0.6 per cent y-o-y to an average mid-rate of Shs. 3,375.6 per USD. The relative stability was largely because of subdued demand for imports and stronger inflows from offshore players.

On a trade-weighted basis, the Shilling was relatively stable, depreciating by 0.1 per cent m-o-m in July 2016, an indication that the currency moved in sync with those of Uganda's trading partners against the US Dollar. On annual basis, the NEER appreciated by 2.2 per cent. The Real Effective Exchange Rate (REER) depreciated by 0.9 per cent, m-o-m, and appreciated by 2 per cent, y-o-y, in June 2016, mainly due to a slower pace of depreciation in the NEER (**Figure 9**). REER appreciation

has negative implications for export sector competitiveness. Depreciation of the bilateral exchange rate, therefore, may be desirable to support the export sector going forward. Supporting the export sector to this end, would also provide room for BOU to continue building reserves. .

Figure 9. Exchange Rates Developments



Source: Bank of Uganda

BoU sold and bought dollars in the IFEM in a bid to stem volatility in the exchange rate market and suspended purchases for reserve build-up on days of elevated volatility. In July 2016, BoU purchased USD 93.7 million for reserve build-up, higher than USD 60.8 million bought in June 2016. Sales to UETCL amounted to USD 15.06 million, bringing the net BOU action in the IFEM during the month to a purchase of USD 78.6 million.

Going forward, sustained government dollar demand for infrastructure projects and other imports, widening current account position, particularly in light of likely continued pickup in international crude oil prices, strife in South Sudan amidst volatile global financial markets could add depreciation pressures to the Shilling. A depreciated exchange rate presents upward pressures to domestic inflation going forward.

6 Inflation

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

6.1 Global Inflation and International Commodity Prices

6.1.1 Global Inflation

Global inflation remains subdued, particularly in AEs, in part driven by low commodity prices and subdued global demand. In June 2016, average inflation in key AEs rose to 0.5 per cent from 0.2 per cent in May 2016, with most of the increase coming from the UK on account of higher prices for services such as restaurants and hotels. In the WEO update for July 2016, inflation in AEs is projected to average 0.7 per cent, and increase to 1.6 per cent in 2017, which remains below the respective central banks medium-term targets.

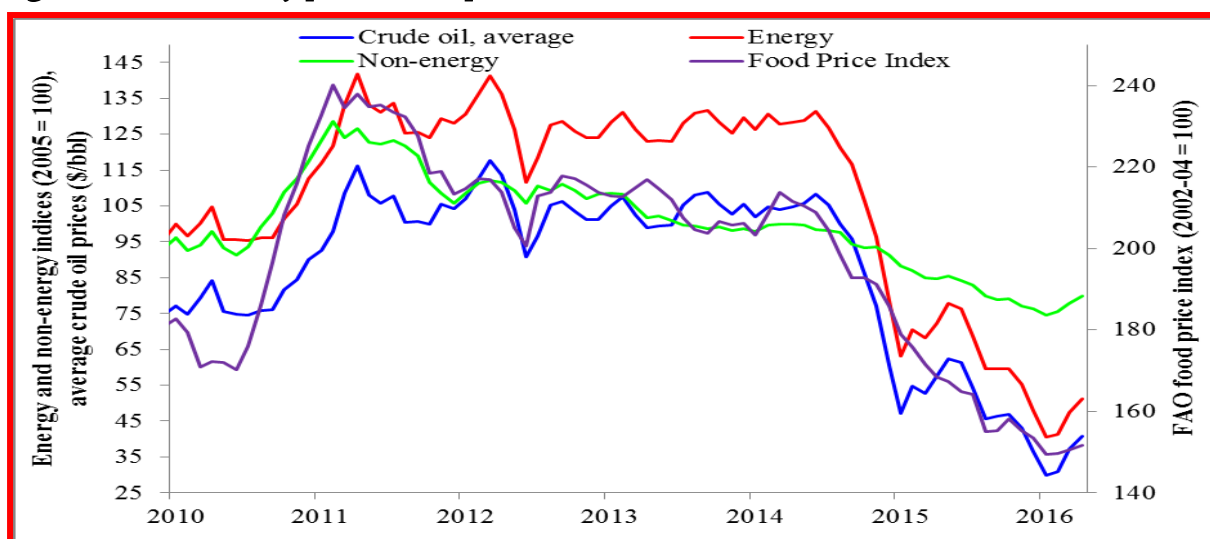
In EMDEs, inflation, which had risen to 4.7 per cent in 2015, is projected to decline slightly to 4.6 and 4.4 per cent in 2016 and 2017, respectively. Nonetheless, inflation remains relatively elevated in EMDEs compared to the trend in AEs, in part driven by the pass-through of sizeable currency depreciations that these economies experienced in 2015.

6.1.2 International Commodity Prices

Global commodity prices declined in 2015 and are projected to remain soft in 2016, reflecting soft global demand amidst abundant supplies. Crude oil prices which averaged USD 50.8 per barrel in 2015, is now forecast to decline to USD 42.9 per barrel in 2016 but rise to USD 50 per barrel in 2017. The rise in oil prices to USD 47.7 per barrel in June 2016 was mainly due to concerns regarding the UK referendum results and production disruptions mainly in Nigeria and Canada. However, the OPEC continues to maintain high production levels.

Global food prices, which had been subdued, rose in June 2016 by 4.2 per cent month –on-month (m-o-m) and by 9.4 per cent from January 2016 due to supply constraints in Brazil and EU. Food prices are expected to rise owing to drought conditions in Southern Africa and South America. The non-energy prices are also projected to remain low in FY 2016/17, driven by excess supply coupled with weak global growth prospects. Developments in international commodity prices are shown in Figure 10.

Figure 10. Commodity price developments

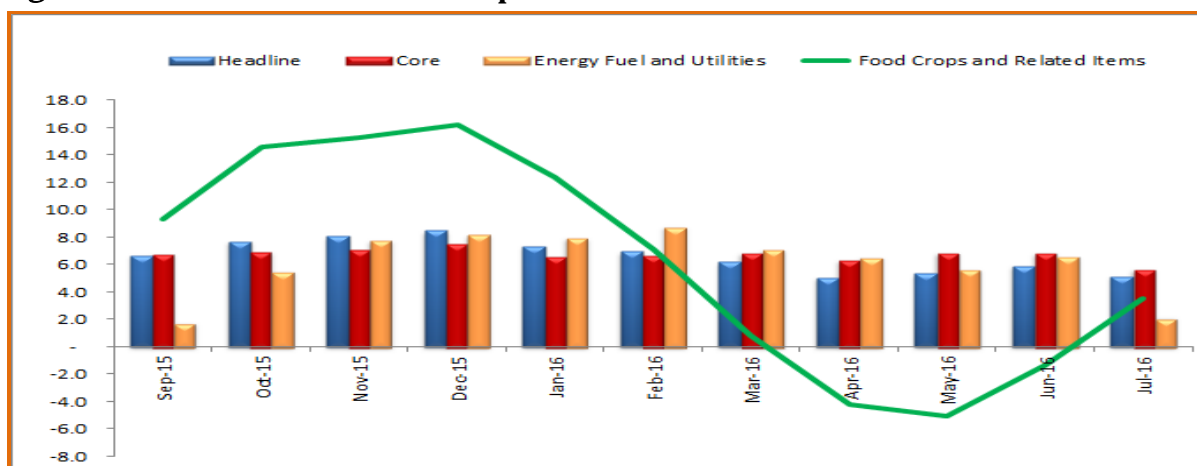


Source: West Texas Index and Food and Agricultural Organization

6.2 Domestic Consumer Price Inflation

The Consumer Price Index (CPI) data for July 2016 indicates that domestic cost pressures remain relatively subdued. All components of inflation save for food crops inflation, declined in July 2016. Annual headline and core inflation declined to 5.1 and 5.7 per cent from 5.9 and 6.8 per cent, respectively in June 2016. Similarly, annual Energy Fuel and Utilities (EFU) inflation declined from 6.6 per cent to 2.1 per cent, and so was other goods, services and non-food inflation, which declined to 5.8, 5.5 and 5.1 per cent, from 7.4, 6.1 and 6.4 per cent, respectively. Annual Food crops inflation however rose to 3.5 per cent from minus 1.3 per cent, largely driven by increases in prices of food crops and related items due to adverse weather conditions. On a monthly basis, headline inflation remained flat while all other components declined except food-related inflation, which picked somewhat. Developments in annual inflation are shown in Figure 11.

Figure 11: Annual Inflation Developments



Source: Uganda Bureau of Statistics

Various components of inflation suggest convergence of inflation to the 5 per cent target, largely due to subdued aggregate demand and relatively stable exchange rate. In the quarter to July 2016, overall inflation eased to an average of 5.4 per cent from 6.1 per cent in the quarter to April 2016. Over the same period, core inflation also eased, albeit slightly, to an average of 6.4 per cent from 6.6 per cent. Other goods inflation also eased to 6.8 per cent from 7.3 per cent. However, services and non-food inflations, edged up to 6.0 and 6.1 per cent, respectively, from 5.6 and 5.9 per cent over the same period.

7 Economic Outlook and Risks

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

7.1 Economic Outlook

The global economic environment continues to have an impact on Uganda’s economic developments. Adverse occurrences in the global arena can affect consumer and investor confidence and curtail growth in the Ugandan economy. The major forces currently driving the global economic outlook are the Brexit, the soft commodity prices and the divergent monetary policy stances.

The upheaval following the Brexit referendum will continue to pose uncertainty in the Global financial markets, and the overall level of economic activity, all of which could have negative impact on Uganda's export earnings, and dampen domestic economic activity. . The positive upturn in activity in the Euro Area, at the beginning of 2016 is expected to be offset by the uncertainty following the Brexit vote, with spill-over effects to EMDEs, including Uganda through trade, financial and confidence channels.

Crude oil prices have been on a decline since mid-2014, and generally low commodity prices in part reflecting supply-side developments and lower growth in global demand. While this could support global activity through keeping domestic inflation in check in oil-importing economies, it could destabilize the outlook for oil-exporting countries, leading to a fall in exports earnings. Uganda, being an oil-importer, benefits from this scenario through the reduction in oil imports bill, hence improvements in her Balance of Payments (BoP). On the other hand, the persistently low oil prices could also depress oil related FDI inflows in Uganda, which have already dwindled. This is bound to adversely affect Uganda's already weak current account position and possibly cause volatility in the foreign exchange market.

7.2 Inflation Outlook

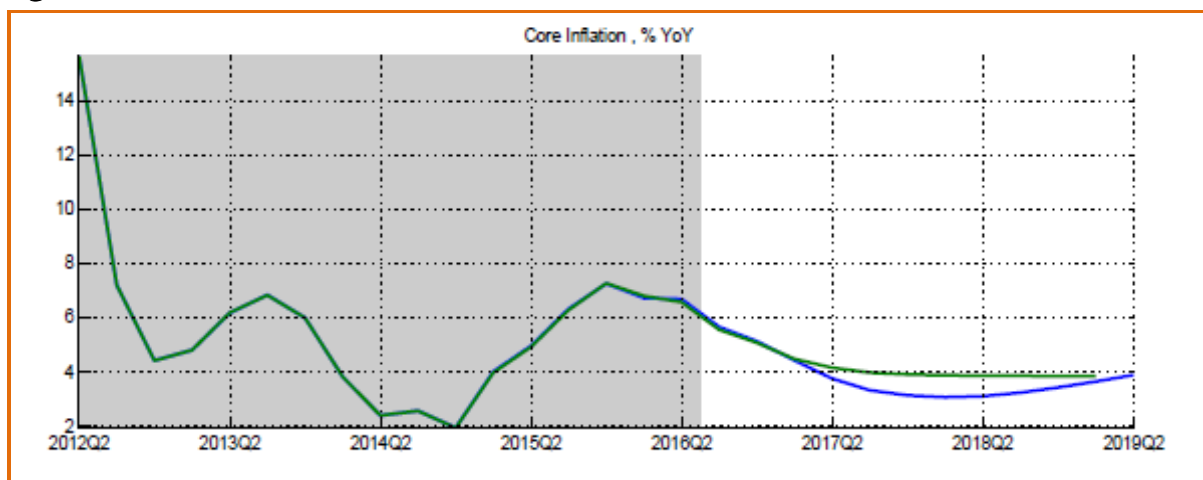
The weak external economic environment will continue to weigh heavily on inflation, both directly through persistently lower import prices and indirectly by dampening domestic economic activity. The recent Brexit has created uncertainty in the global economy with dire implications for global financial markets. Global commodity prices remain soft, and in particular, oil prices remain low and below USD 60 per barrel. Food prices also remain soft, but are expected to increase modestly on account of the projected poor harvests. Global inflation is set to remain below 2 per cent on account of low commodity prices and weak global demand conditions. The global output gap remains negative and is projected to remain so, at least in the near term.

The exchange rate continues to be a critical determinant of the inflation trajectory, given the high percentage of tradable goods in the consumption basket with an imported component. Instability in South Sudan, continued volatility in global financial market following the Brexit and increase domestic demand for foreign currency could lead to a widening current account deficit and this could result in depreciation pressures on the exchange rate.

Economic growth remains below potential and is forecast to remain so, at least in the near-term. The negative capacity gap constitutes a downside risk to domestic inflation. The subdued aggregate demand and subdued growth in credit pose downside risks to domestic inflation. Compared to the June Forecasts, the revised outlook for headline and core inflation is softer in the near term. Both headline and core inflation are projected to decline gradually to about 5.0 per cent by Q4-2016. Although the exchange rate is expected to depreciate in the near term, its impact on domestic inflation is expected to be offset by the negative output gap.

The core inflation forecasts are shown in **Figure 12**.

Figure 12: Core Inflation forecast



Source: Bank of Uganda

7.3 Risks

While the baseline scenario estimates the most likely predictions given the available information, there are risks that could alter the outcome of the forecasts. The upside risks mainly emanate from the external economic environment which remains volatile. The recent Brexit has created uncertainty in the global economy, which could heighten volatility in the global financial markets. This coupled with the fragility of South Sudan could exert upward pressure on the exchange rate. The current account is likely to widen further in the face of continued weakness in commodity prices, higher import content of government expenditures and the expected decline in exports to South Sudan. Weather related risks continue to affect domestic food prices. Food crops prices have reversed trend since June; but the full impact of the current dry spell in central region and other major food producing regions of the country is yet to be reflected in prices. Higher fiscal spending

and payment of domestic arrears to government suppliers could contribute to growth in domestic demand.

On the other hand, world commodity and oil prices remain subdued and are predicted to continue falling in the near term. This could dampen domestic inflation. The continued weak global environment, in terms of low global demand and inflation are likely to exert downward pressures on domestic inflation. In addition, the subdued domestic aggregate demand reflected in the negative output gap and the declining growth in the private sector credit pose downside risks to domestic inflation.

8 Conclusion

The economy continues to recover at a gradual pace supported by public investment and domestic consumption. However, private investment seems to have weakened, unexpectedly, reflecting a number of factors, both global and domestic. Globally, the slowdown in growth of global demand and heightened uncertainty, on account of the Brexit, has contributed to the downturn in investment. Domestically, the pass-through of Q3-2015 depreciations of the exchange rate has caused a decline in investment in addition to the tight financial conditions and uncertainty relating to elections. Furthermore, the weak global demand is set to cause a contraction in merchandise exports and thereby dampen the contribution of the external sector to overall economic growth.

The output gap is expected to close somewhat later than indicated in June 2016, towards the end of 2017. However, the timing of the closing of the gap is highly uncertain and dependent on the revisions to projections of both real GDP and potential output. The profile for potential output depends on the projection for investment spending, and both are currently subject to unusual uncertainty as a result of the economy's ongoing complex structural adjustment as well as the difficult-to-forecast effect of Brexit.

Inflation continued to decline in July 2016, mainly driven by a relatively stable exchange rate and weak global and domestic environment. Nonetheless, the let-up could be temporary if exchange rate depreciation pressures re-emerge. While it is assumed that the exchange rate will remain stable over the forecast period, a number of influences, both domestic and external may cause upheavals. The external economic environment remains volatile, with substantial upside risks. In particular, the recent Brexit has created uncertainty, which is likely to have implications on global financial

markets. This coupled with the instability in South Sudan could further put upward pressures on the exchange rate.

Domestically forex demand, particularly for public infrastructure projects continues to grow. This may increase demand pressures in the foreign exchange market given the widening current account deficit. While there are signs that the growth cycle in the economy may have bottomed out, the recovery is expected to be slow, and is subject to downside risks. The improvement in the inflation outlook is nonetheless contingent on the speed at which the hindrances from imported cost pressures diminish the exchange rate movements, inflation expectations and the impact of weather-related risks on domestic food prices. Indeed, food crops prices reversed trend since June and the full impact of the dry spell is yet to be reflected in prices.

Presently, the Bank of Uganda judges that the risks to the projected path for inflation are roughly on the downside and inflation is projected to return to the target band slightly faster than previously assessed. Therefore, Bank of Uganda considered it appropriate to, further, ease the monetary policy to support recovery of economic activity. The CBR was reduced to 14 per cent. The band on the CBR was maintained at +/-3 PPs and the margin on the rediscount rate at 4.0 PPs on the CBR. The rediscount rate and the bank rate are therefore 18 per cent and 19 per cent, respectively.