Bank of Uganda

Monetary Policy Report

June 2020

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Acronyms and Abbreviations

AEs	Advanced Economies
BoP	Balance of Payments
BoU	Bank of Uganda
CA	Current Account
CBR	Central Bank Rate
CPI	Consumer Price Index
EU	European Union
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
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
REPOs	Repurchase Agreements
SSA	Sub- Saharan Africa
T-Bills	Treasury bills
T-Bonds	Treasury bonds
UK	United Kingdom
US	United States
WEO	World Economic Outlook

Executive Summary

The COVID-19 pandemic has adversely affected the already-fragile global economy. Lockdowns and other restrictions needed to address the public health crisis, together with spontaneous reductions in economic activity by many consumers and producers, constitute an unprecedented combination of adverse shocks that is causing deep recessions in many advanced economies (AEs) and emerging market and developing economies (EMDEs). While the ultimate growth outcome is still uncertain, and an even worse scenario is possible if it takes longer to bring the health crisis under control, the pandemic will result in output contractions across the vast majority of AEs and EMDEs.

Indeed, the International Monetary Fund (IMF) World Economic Outlook (WEO) for April 2020 projected that the global economy will contract by 3 percent in 2020. In particular, AEs were projected to contract by 6.1 percent while EMDEs were projected contract by 1 percent. In Sub-Saharan Africa (SSA), economic activity was projected to contract by 1.6 percent. It was also observed that EMDEs that have weak health systems; those that rely heavily on global trade, tourism, or remittances from abroad; and those that depend on commodity exports will be particularly hard-hit. Moreover, the pandemic is likely to exert lasting damage to fundamental determinants of long-term growth prospects, further eroding living standards for years to come. The global economy was however projected to recover in 2021, growing by 5.8 percent provided that the containment measures are eased in H2-2020 and market confidence restored through policy support measures implemented to limit household and business financial distress.

The outbreak of COVID-19 and the wide-ranging measures needed to slow its advance have precipitated an unprecedented collapse in oil demand, a surge in oil inventories, and, in March 2020, the steepest one-month decline in oil prices on record. In the context of the current restrictions on a broad swath of economic activity, low oil prices are unlikely to do much to buffer the effects of the pandemic, but they may provide some initial support for a recovery once these restrictions begin to be lifted.

Many countries have provided large-scale macroeconomic support to alleviate the economic blow, which has contributed to a recent stabilization in financial markets. Central banks in advanced economies have cut policy rates and taken other far-reaching steps to provide liquidity and to maintain investor confidence. In many EMDEs, central banks have also eased monetary policy. The fiscal policy support that has been announced already far exceeds that enacted during the 2008-09 global financial crisis.

Financial markets have been extremely volatile, reflecting exceptionally high uncertainty and the worsening outlook. Flight to safety led to a sharp tightening of global and EMDE financial conditions. Equity markets around the world plunged, spreads on riskier categories of debt widened considerably, and EMDEs experienced large capital outflows in much of March and April 2020 that bottomed out only recently. Commodity prices have declined sharply as a result of falling global demand, with oil particularly affected.

On the domestic scene, the money market rates have moved in line with the monetary policy stance. Following the reduction of the CBR to 8 percent in April 2020, the weighted average 7-day interbank money market rate declined to 8.6 percent and 8.4 percent in April and May, respectively, from 10.3 percent in March 2020. Indeed, the CBR continues to anchor movements in the 7-day money market rates.

Yields on Government securities declined in April and May 2020, having risen substantially in January 2020. At the short end, the yields on the 91-day and 364-day Treasury bills declined to average 9.3 percent and 12.6 percent, respectively, in April and May compared to 9.7 percent and 13.6 percent in January 2020. The yields on the 2-year Treasury bonds also declined though marginally from an average of 14.1 percent in January 2020 to 14.0 percent in April and May 2020, while the yields on the 5-year and 15-year Treasury bonds remained relatively stable at 16.5 percent and 15.5 percent, respectively in the same period.

Notwithstanding the uncertainty around the severity and the persistence of the pandemic, yields remained relatively stable on account of the policy response measures that have contributed to reinforcing confidence in financial markets. However, the planned increase in fiscal financing requirements from Shs. 2.6 trillion in FY 2019/20 to Shs. 3.1 trillion in FY 2020/21 could put upward pressure on the yields going forward, particularly in the first quarter of FY 2020/21.

Commercial bank lending interest rates continued to decline in line with the accommodative monetary policy stance. Lending rates on Shilling denominated loans declined to 17.8 percent in March and April 2020, respectively from 19.12 percent in February 2020. Lending rates on foreign currency denominated loans also declined marginally to 6.2 percent and 6.6 percent in March and April 2020, respectively from 6.7 percent in February 2020.

Growth in private sector credit (PSC), a key indicator of financial conditions in the economy has slackened in the recent past. While this trend is evident from July 2019, the decline in the recent past can largely be attributed to the adverse consequences of the covid-19 pandemic on the economy. Indeed, annual growth in PSC declined to single digit levels in March and April 2020. It declined from 11.7 percent in February 2020 to 9.5 percent and 9.8 percent in March 2020 and April 2020, respectively. Specifically, shilling denominated loans grew by 13.9 percent and 13.5 percent, respectively compared to 17.7 percent in February 2020. Foreign currency denominated loans however grew by 1.0 percent and 2.6 percent compared to 0.2 percent during the same period. Net of foreign exchange valuation changes, annual PSC grew by 9.2 percent and 9.5 percent in March 2020 and April 2020, respectively down from 12.1 percent in February 2020.

Value of loan approved in April 2020 was down by 83 percent compared to March 2020. Real estate prices and invariable collateral valuations are likely to be depressed in the COVID-19 aftermath, which may amplify banking institutions' expected credit losses, and worsen their solvency. Liquidity and funding conditions tightened in March and April 2020. As market volatility increased, outflow of offshore investors picked up and the exchange rate depreciated sharply, leading to a rise in systemic liquidity pressures as well as higher borrowing costs and tightening of credit lines for some banks.

COVID-19 has affected economic activity, adversely affected borrowers' ability to meet loan obligations, tightened liquidity, affected bank's operations and poses a serious threat to financial system stability. Asset quality deteriorated through the year ended March 2020, as the NPL ratio rose from 3.8 percent in June 2019 to 5.4 percent. Annually, the stock of NPLS rose by 57.3

percent from USh.498.4 billion to USh.782.6 billion. Q-o-Q, NPLs increased by 15.7 percent, in March 2020. Watch loans also rose sharply, a leading indicator that NPLs are likely to pick up in the near term. The economic downturn arising from Covid-19 is expected to increase NPLs further, but this effect will be moderated by the BOU credit relief measures. NPL ratios for Agriculture, Electricity & water, and Personal/household loans registered the largest increase. NPLs are forecast to rise to a range of 6.1 percent to 12.3 percent between June 2020 and December 2020. Banks have become risk averse and responded by reducing lending, driven by concerns about asset quality as well as significant uncertainty about economic recovery.

Fiscal operations during the first ten months of FY 2019/20 were less expansionary than programmed. The implementation of the budget was constrained by a shortfall in domestic revenue, lower than target financing and the slow execution of infrastructural projects. While the shortfall in revenues can generally be attributed to the less than programmed growth, the less than optimal revenue performance since March 2020 is largely a reflection of the adverse consequences of the pandemic on the economy. Indeed, total Government revenues (including grants) in the ten months of FY2019/20 amounted to Shs. 15,048.7 billion, which was Shs. 3,128.8 billion lower than the approved budget. Grants amounted to Shs. 662.9 billion, which was Shs. 893.9 billion lower than programmed; while domestic revenue amounted to Shs. 14,385.8 billion, which was Shs. 2,234.8 billion lower than the approved budget

The provisional total public debt stock as at end April 2020 stood at Shs. 53,697.6 billion, an increase of about 13.7 percent relative July 2019. The ratio of debt as a percentage GDP stood at 39.1 percent in nominal value terms as at end April 2020 and 29.7 percent in present value terms, as at end March 2020. The recent loans acquired during the COVID-19 pandemic could possibly push the ratios up in part also due to weaker fundamentals, including slower growth, exchange rate depreciation, weaker exports and a fragile domestic revenue base.

External debt continues to be the dominant component of public debt, accounting for 68.4 percent, while domestic debt accounts for 31.6 percent. Although most of the external debt is from multilateral creditors, there has been a significant increase in semi-and non-concessional borrowing, in part reflecting increased borrowing from bilateral lenders, particularly China.

While Uganda remains at low risk of debt distress, significant vulnerabilities are evident. Although the multilateral creditors have put in place facilities to dampen the adverse effects of the COVID-19 pandemic, uncertainties relating to the ensuing expenditure pressures, subdued economic activity and declining tax revenues, and a possible further decline in grants could lead to further borrowing on non-concessional terms. The associated increase in interest payments will be a substantial drain on resources that could have otherwise been used to finance development.

The resource envelop for the FY 2020/21 is Shs. 45,493.7 billion. The revenue target is Shs. 21,810 billion, which translates to 14.3 percent of GDP. To achieve this target, the government is not only expected to broaden the tax base through digitization and use of electronic fiscal devices, but also improve tax administration. The government has also announced a package of fiscal policy measures in the FY 2020/21 budget aimed at resuscitating the economy from the adverse consequences of the COVID-19 pandemic. These initiatives broadly include:

(i) **Tax relief to businesses:** the government will defer payment of corporate tax income or presumptive tax for corporations and small and medium enterprises (SMEs); and will also defer the payment of PAYE until September 2020 by sectors most severely affected by COVID-19 pandemic such as manufacturing, tourism and floriculture. In addition, government has waived interest on tax arrears, provide for tax deductibility of donations for coronavirus response and will expedite payment of outstanding VAT refunds.

(ii) **Restoring household incomes and safeguarding jobs**: government will enhance the provision of improved agricultural inputs using the NAADs; create jobs for the vulnerable but able bodied persons affected by the coronavirus by extending labour intensive public works in urban and peri-urban areas; provide rainwater harvesting technologies in rural communities; roll-out regional and community based storage facilities; provide seed capital to organised special interest groups under the Youth Fund, Women Entrepreneurship Fund and the "Emyooga" talent support scheme.

(iii) **Re-igniting business activity:** government will provide credit through SACCOs and Micro Finance Institutions to support Micro and Small-Scale Enterprises; increase access to credit by providing Shs. 1.045 trillion over the medium term to Uganda Development Bank (UDB) to offer low interest financing; expedite the payment of domestic arrears.

The government has also committed to enhance economic infrastructure by undertaking emergency maintenance of roads and bridges destroyed by floods, developing warehousing capacity to restore supply chains and promote exports, expediting construction of priority industrial parks and special economic zones, rehabilitating the meter gauge railway and improving water transport safety. The combination of monetary policy and fiscal policy measures is expected to enhance the economic recovery in FY 2020/21. However, in spite of these efforts, effective financial support and mitigation measures are particularly hard to achieve because a substantial share of employment is in informal sector.

The external position was relatively weak in the twelve months to April 2020. The overall balance of payments position was a deficit of US$ 125 million, as the financial account inflows were insufficient to finance the current account deficit (CAD). The CAD however narrowed by to US$ 2,326.9 million compared to a deficit of US$ 2,601.6 million during the twelve months to April 2019. This improvement was mainly driven by a decline in imports, a reduction in investment income and an improvement in private transfers.

In FY 2020/21, the current account deficit is projected to deteriorate further US$3,853.4 million, driven by a faster recovery in imports amidst subdued export earnings, and a decline in tourism earnings and personal transfers on account of the prolonged adverse consequences of the pandemic. FDI inflows are projected to remain subdued in FY2020/21 while it is anticipated that loan disbursements will pick up as donors provide funding to mitigate the effects of the COVID-19 pandemic. Reserves are expected to further decline from 4.0 future months of imports in FY 2019/20 to about 3.2 future months of imports by the end of FY2020/21.

After heightened depreciation pressures in March 2020 largely driven by market sentiments and panic on account of the uncertainty created by the COVID-19 pandemic which led to exit of offshore investors, speculative tendencies and the usual demand for dividend payments from manufacturing, the shilling remained relatively stable in April and May 2020. The demand for foreign exchange was subdued partly driven by low imports and a slowdown in economic activity. In May 2020, the shilling depreciated marginally by 0.15 percent month-on -month and 0.69 percent year-on- year to an average mid-rate of Shs.3,791.5/USD. On the regional front, the Kenya Shilling and Uganda Shilling experienced some volatility during the three months to April 2020 before stabilising in May 2020. Going forward, the exchange rate is expected to remain relatively stable in the short run. However, in the medium term, depreciation pressures could emerge with a worsening current account deficit.

The COVID-19 pandemic has had adversely effects on economic activity. The recent preliminary estimates by the Uganda Bureau of Statistics (UBOS) projects that GDP growth slowed down to 3.1 percent in FY 2019/20 down from 6.8 percent in FY 2018/19. Growth was largely driven by the improvement in the agriculture sector, which grew by 4.2 percent. The services and industrial sectors were relatively subdued, growing by 3.6 percent and 2.3 percent, respectively. Beyond its short-term impact, the pandemic is likely to leave lasting scars through multiple channels, including lower investment; erosion of the human capital of the unemployed; and a retreat from global trade and supply linkages through import substitution. These effects may well lower potential growth and labor productivity in the longer term.

Although Uganda is gradually easing the lockdown measures instituted to contain the spread of the pandemic, the adverse consequences of the global and domestic supply chain disruptions could persist through the remaining part of 2020. If COVID-19 outbreaks persist longer than expected, restrictions on movement and interactions may have to be maintained or reintroduced, prolonging the disruptions to domestic activity and further setting back confidence. Disruptions to activity would weaken businesses' ability to remain in operation and service their debt, while the increase in risk aversion could raise interest rates for higher-risk borrowers.

For now, while the economic slowdown will be severe in the second quarter of 2020, a gradual recovery is expected to set in during the third and fourth quarters. On the whole, household expenditure, investment, exports and imports are projected to decline in 2020. Accordingly, BoU has revised down its projection of economic growth to a range of 2.5 to 3.5 percent in 2020 from the April 2020 forecast of 3 to 4 percent. Although uuncertainty around the outlook remains exceptionally high, BoU projects that the economy will expand by 4 - 5 percent in 2021, increasing further to 6 - 6.5 percent in 2022. The output gap is expected to remain negative over the entire forecast horizon and will close only gradually. The strength of the economic recovery will depend in part on how Uganda will be able to open up for economic activity safely, and in particular how effectively the public will comply with social distancing rules. Resumption of pre-pandemic levels of economic activity will be gradual, partly due to dampened external demand amidst the deterioration in global economic sentiment. The combination of the COVID-19 pandemic, extreme weather, and volatility in the global financial markets, could weigh-down Uganda's balance of payments, potentially destabilizing the domestic foreign exchange market and dampen economic growth.

Consistent with the slowdown of economic activity, inflation had remained subdued. The headline and core inflation declined to 2.8 percent and 3.2 percent, respectively, in May 2020, from corresponding levels of 3.2 percent and 3.4 percent in April 2020. The public transport measures to contain the pandemic will temporally increase transport costs in months ahead but the overall risks to the inflation outlook appear to be to the downside. The economic slowdown and a gradual recovery will keep inflation below the medium-term target of 5 percent in the near term (12 months ahead). Moreover, external sources of inflation are likely to remain weak in the near term amid the global economic downturn and food crop inflation is also expected to remain contained. Risks to inflation from shilling depreciation are expected to stay low as pass-through of exchange rate depreciation to inflation is expected to remain slow due to subdued demand.

Decisive measures taken by BOU since March 2020 to alleviate the impact of the Covid-19 pandemic on economic growth and the financial sector, include:

- Reducing CBR from 9 percent in March 2020 to 8 percent in April 2020 and to 7 percent in June 2020.
- Reduced the band on the CBR by 1 percentage point to +/-2 percentage points,
- Set up a Liquidity Assistance Program for all supervised financial institutions (SFIs) facing liquidity pressures. This includes facilities for MDIs and Cis that previously had no direct access to BOU liquidity.
- Provided exceptional permission to SFIs to provide credit relief and loan restructuring to borrowers that may be at risk of going into distress due to the COVID-19 pandemic, for one-year effective 1st April 2020.
- Deferred payment of all discretionary distributions until further notice, in order to enable SFIs to build up capital and liquidity reserves during the Covid-19 period and continue to operate effectively.
- Directed SFIs to leverage and promote the use of digital platforms, in cooperation from the Mobile Network Operators in order to minimize human interaction.
- Set a limit of 85 percent on loan to value for new residential mortgage loans and loans for land purchase, with effect from 1st June 2020, in order to alleviate the risk of bank losses from potential reduction in property prices/collateral valuation

1. Background

This report presents the global and domestic economic developments in the period to May 2020. In particular, it assesses the impact of the Covid-19 pandemic on the economy and the efficacy of the economic policy actions undertaken thus far to contain the adverse consequences of the pandemic on the economy. It also presents the risks to the domestic economic outlook, the policy challenges in the medium term and the implications of the domestic economic outlook for the future direction of monetary policy in Uganda.

2. Global Economic Environment

2.1. Global Economic Growth

The COVID-19 pandemic is a global health crisis without precedent in living memory that has triggered the most severe economic recession in nearly a century. The pandemic and the associated containment measures (lockdowns, closure of schools and non-essential businesses, and travel restrictions) have plunged the global economy into a deep recession. In April 2020, the International Monetary Fund (IMF) World Economic Outlook (WEO) projected that the global economy will contract by 3 percent in 2020. In particular, Advanced Economies (AEs) were projected to contract by 6.1 percent while Emerging Market and Developing Economies (EMDEs) were projected contract by 1 percent. In Sub-Saharan Africa (SSA), economic activity was projected to contract by 1.6 percent. It was also observed that EMDEs, especially commodity exporters remained fragile with collapsed commodity prices, elevated capital outflows leading to currency depreciations and severely low external demand. The global economy was however projected to recover in 2021, growing by 5.8 percent provided that the containment measures are eased in H2-2020 and market confidence restored through policy support measures implemented to limit household and business financial distress.

The June 2020 projections by the World Bank are largely consistent with the IMF WEO. Global output is projected to contract by 5.2 percent in 2020, but recover and expand by 4.2 percent in 2021. EMDEs are projected to contract by 2.5 percent in 2020, but a recovery of 4.6 percent is projected in 2021. The contraction of activity in EMDEs in 2020 is a reflection of the impact of the demand and supply shocks on global trade, supply chains, remittances, and tourism. In SSA, economic activity is projected to contract by 2.8 percent in 2020, largely reflecting huge contractions in Nigeria, Angola and South Africa. The June 2020 World Bank projections of global output are shown in **Table 1.**

Table 1: Real GDP in selected Countries

	June-2020 Forecasts				Percentage point diff. from January 2020 projections	
	2018	**2019e**	**2020f**	**2021f**	**2020f**	**2021f**
World Output	**3.0**	**2.4**	**-5.2**	**4.2**	**-7.7**	**1.6**
Advanced economies	**2.1**	**1.6**	**-7.0**	**3.9**	**-8.4**	**2.4**
United States	2.9	2.3	-6.1	4.0	-7.9	2.3
Euro Area	1.9	1.2	-9.1	4.5	-10.1	3.2
Japan	0.3	0.7	-6.1	2.5	-6.8	1.9
Emerging market and developing economies	**4.3**	**3.5**	**-2.5**	**4.6**	**-6.6**	**0.3**
China	6.6	6.1	1.0	6.9	-4.9	1.1
Brazil	1.3	1.1	-8.0	2.2	-10.0	-0.3
India	6.1	4.2	-3.2	3.1	-9.0	-3.0
South Africa	0.8	0.2	-7.1	2.9	-8.0	1.6
SSA	2.6	2.2	-2.8	3.1	-5.8	0.0

Note: e=estimate; f=forecast

Source: World Bank

There are nonetheless downside risks to the global economic forecasts. The pandemic could persistent through H2- 2020 or there could be a second wave of the pandemic, with adverse consequences for the global economy. In addition, high debt levels in EMDEs and heightened currency depreciations in these economies, in part driven by the widening current account deficits in the face of increased capital outflows could lead to debt distress. The fall in commodity prices could also negatively impact economic growth especially for the countries that are heavily dependent on exports of commodities. Furthermore, the resurgence of the US-China tensions could increase uncertainty in the global economy, with severe consequences for the global financial system.

2.2. Global Commodity Prices and Inflation

2.2.1 Commodity Prices

Global commodity prices fell sharply in the first four months of 2020, largely reflecting the disruptions to the global supply chains and the impact of the depressed global demand induced by the world-wide containment measures implemented to slowdown the spread of the pandemic. Energy prices registered the highest decline, especially in March 2020 through April 2020, largely driven by the fall in demand for oil on account of the travel ban and the decline in global economic activity. In addition, the collapse of global crude oil prices was further hastened by the failure by the Organization of Petroleum Exporting Countries (OPEC) to agree on oil production cuts. Indeed, crude oil prices declined sharply, averaging US$ 21.04/barrel in April 2020, with the US West Texas Intermediate(WTI) crude oil prices crushing to about US$-37.63/barrel for the first time in history. However, crude oil prices somehow picked-up in May, 2020, increasing by about 44 percent to average US$ 30.38/barrel during the month. Non-energy and food prices also declined during the five months to May 2020, in part reflecting the impact of suppressed global demand and the lockdown measures. Developments in global commodity price are shown in **Figure 1.**

Figure 1: Global Commodity Price Developments

Source: World Bank

Going forward, global commodity prices are projected to remain subdued in 2020, largely reflecting the slow economic activity. However, commodity prices are projected to recover in 2021, as economic activity strengthens. In particular, crude oil prices are projected to average US$ 35/barrel and US$ 42/barrel in 2020 and 2021, respectively. Food prices are however projected to remain fairly stable in 2020, since they are less responsive to changes in economic activity.

2.2.2 Global Inflation

Consistent with the evolution of global commodity prices and the contributing factors, global inflation fell sharply during the first five months of 2020 as shown in **Table 2.** Going forward, a combination of suppressed global economic activity and lower international commodity prices is likely to keep global inflation benign. The envisaged subdued global inflation could help moderate Uganda's inflation.

Table 2: Annual Inflation Rates in Selected Countries

	Jan-20	Feb-20	Mar-20	Apr-20	May-20
Euro Area	1.4	1.2	0.7	0.3	0.1
Japan	0.7	0.4	0.4	0.1	0.2
UK	1.8	1.7	1.5	0.9	0.8
US	2.5	2.3	1.5	0.3	0.1
Brazil	4.2	4	3.3	2.4	1.9
China	5.4	5.2	4.3	3.3	0.8
India	7.5	6.8	5.5	5.4	3.3
Russia	2.4	2.3	2.5	3.1	3
South Africa	4.4	4.5	4.1	4.6	4.1

Source: OECD Statistics and respective central banks

2.3 Global Financial Markets

The COVID-19 pandemic caused a virtual collapse of asset prices and heightened market volatility spiked. The pandemic led to a sharp increase in global risk aversion and an abrupt retrenchment in foreign capital flows to EMDEs. EMDEs experienced the sharpest reversal of portfolio flows and heightened depreciation pressures. Consequently, financial conditions tightened at an unprecedented rate. Sovereign borrowing spreads widened and global equity valuations recorded sizeable losses, suggesting increased investors risk perception on borrowers. Nonetheless, resolute financial and macroeconomic policies — aimed at containing the fallout from the pandemic — managed to stabilize investor sentiment.

Many central banks responded to the deteriorating financial market conditions by injecting liquidity through interest rate cuts, relaxing credit conditions, undertaking large scale asset purchases, and directly providing credit to some sectors. While, these policy measures have greatly improved market sentiments, global financial conditions remain fragile, reflecting a combination of rapid debt accumulation, reduced cash flows, and wide current account deficits in many EMDEs. The prevailing global financial markets fragility, coupled with the relatively wide current account deficits, declining remittances, and disrupted tourism activity may continue to exert exchange rate depreciation pressures in many EMDEs, including Uganda.

3. Domestic Economic Developments

3.1 Reflections on the Previous Monetary Policy Decision

In the April 2020 monetary policy committee (MPC) meeting, BoU reduced the CBR by 1 percentage point to 8 percent. This decision was premised on the need to ameliorate the deteriorating macroeconomic conditions and ensure the normal functioning of financial markets and adequate access to credit by households and businesses. The band on the CBR was maintained at remain at +/-3 percentage points and the margin on the rediscount rate and bank rate was also maintained at 4 and 5 percentage points on the CBR, respectively. Consequently, the rediscount rate and the bank rate were set at 12 percent and 13 percent, respectively.

The COVID-19 pandemic had led to a severe contraction in economic activity. Consequently, the economy was projected to slow down drastically in the second half of Financial Year (FY) 2019/20, with GDP growth for the FY projected at 3 – 4 percent. Downside risks to the economic growth outlook had also increased, particularly in the near term and economic activity was projected to remain subdued, at least in the short-term. On the other hand, inflationary pressures remained muted, with forecasts indicating that core inflation would be in the range of 2 - 4 percent in 2020, and return to the 5 percent target in the medium-term. The inflation forecasts were nonetheless susceptible to a number of upside risks, including a worsening current account balance that could put pressure on the exchange rate, a rising fiscal deficit and adverse weather conditions coupled with the adverse impact of the locust invasion on agricultural output that could stoke food crop inflation. However, these upside risks were approximately balanced by the downside risk on account of low world oil prices and the demand constraints related on account of the prolonged lock-down measures.

Furthermore, in order to ensure that financial institutions have adequate capital buffers, ease liquidity constraints in the banking system and alleviate the financial stress experienced by households and businesses, BoU directed all Supervised Financial Institutions (SFIs) to defer dividend and bonus payments for at least 90 days effective March 2020 and in addition decided to:

(i) Provide exceptional liquidity assistance to commercial banks that are in liquidity distress for a period of up to one year.

(ii) Provide liquidity to commercial banks for a longer period through issuance of reverse REPOs of up to 60 days at the CBR, with opportunity to roll over.

(iii) Purchase Treasury Bonds held by Microfinance Deposit taking Institutions (MDIs) and Credit Institutions (CIs) in order to ease their liquidity distress whenever it arises.

(iv) Grant exceptional permission to SFIs to restructure loans of corporate and individual customers including a moratorium on loan repayment for borrowers that have been affected by the pandemic, on a case by case basis at the discretion of the SFIs for up to 12 months, effective April 1st, 2020.

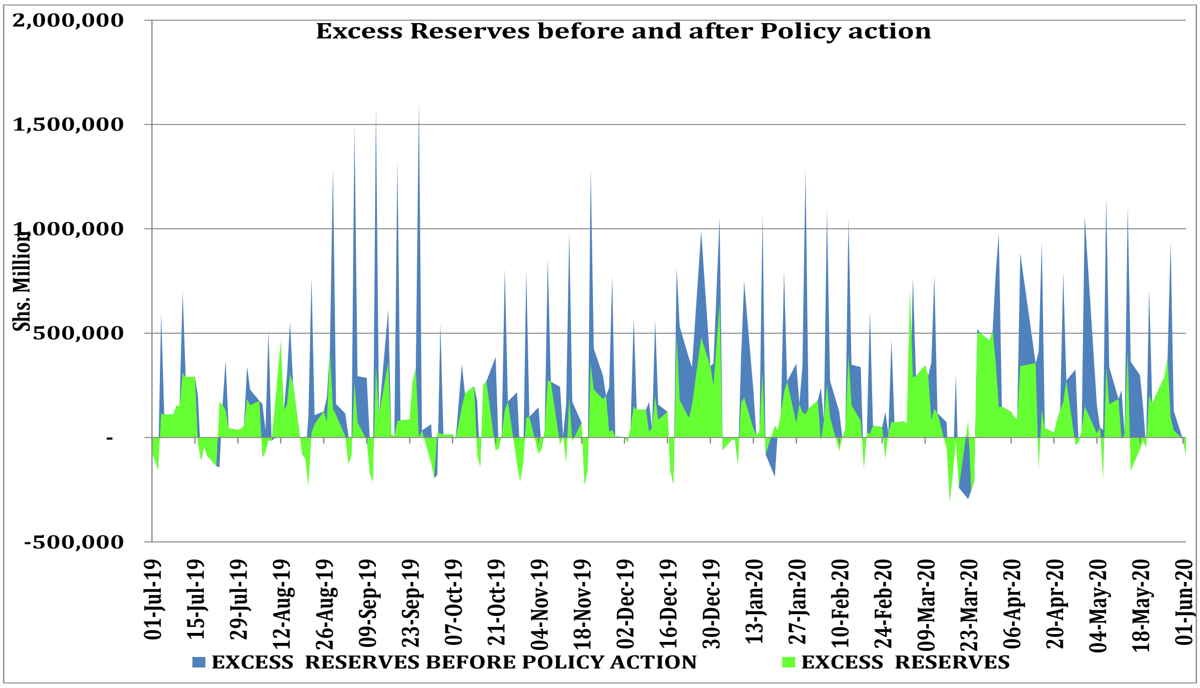
The following sections assess the performance of the economy and the efficacy of economic policy actions undertaken thus far to ameliorate the adverse consequences of the pandemic on the economy. In addition, it also discusses the risks to the domestic economic outlook and the implications for the future direction of monetary policy in Uganda.

3.2 Financial Sector Developments

3.2.1 Liquidity Conditions

The liquidity conditions in the banking system remained relatively eased in line with the accommodative monetary policy stance. Indeed, as shown in **Figure 2**, the level of commercial banks' excess reserves remained substantial in the period to May 2020 in line with BoU policy of maintain sufficient liquidity in the banking system. Indeed, more often than not, BoU had to withdraw liquidity in order to maintain order in the market and minimise the possibility of speculative tendencies in the money market that could have resulted in volatility in the foreign exchange market.

Figure 2: Evolution of Excess Reserves



Source: Bank of Uganda

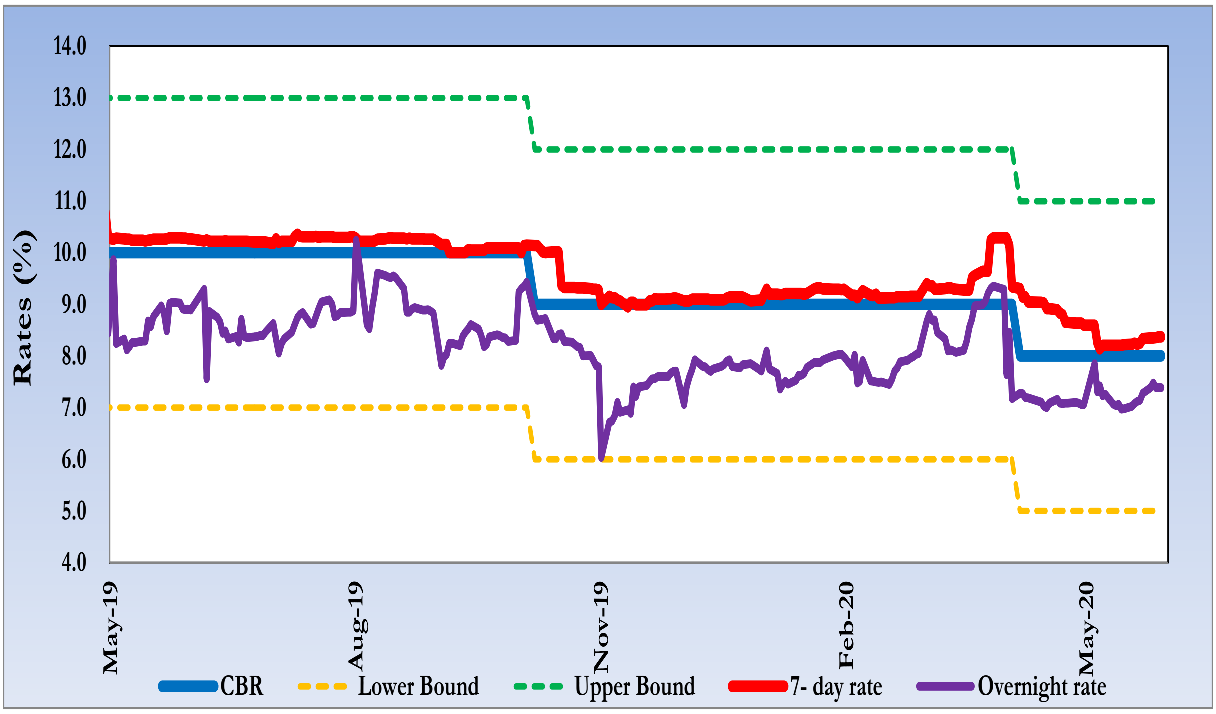
Repurchase Agreements (REPOs)/reverse REPOs, deposit auctions, and the sale of recapitalisation securities were used to align liquidity conditions in the domestic interbank market with the desired monetary policy stance. The net outstanding stock of REPOs and deposit auctions as at end May 2020 was Shs. 763.1 billion and Shs. 916.2 billion, respectively. BoU also conducted secondary market sales of recapitalization securities, mopping-up Shs. 176.2 billion in the quarter to May 2020. Given the level of structural liquidity in the economy, BoU had by 7th May 2020 sold all the available stock of recapitalization securities. The maturity of Shs. 100 billion in Treasury bonds of recapitalization securities that was due on 14th May 2020 was also rolled-over, following approval from Ministry of Finance, Planning and Economic Development. The available stock of securities at June 8th was Shs. 7.5 billion.

3.2.2 Interest Rate Developments

3.2.3.1 Interbank Money Market Rates

The money market rates moved basically in line with the monetary policy stance. Following the reduction of the CBR to 8 percent in April 2020, the weighted average 7-day interbank money market rate declined to 8.6 percent and 8.4 percent in April and May 2020, respectively, from 10.3 percent in March 2020. Indeed, the CBR continues to anchor movements in the 7-day money market rate as depicted below in **Figure 3.**

Figure 3: The 7-day Interbank Rate and Central Bank Rate



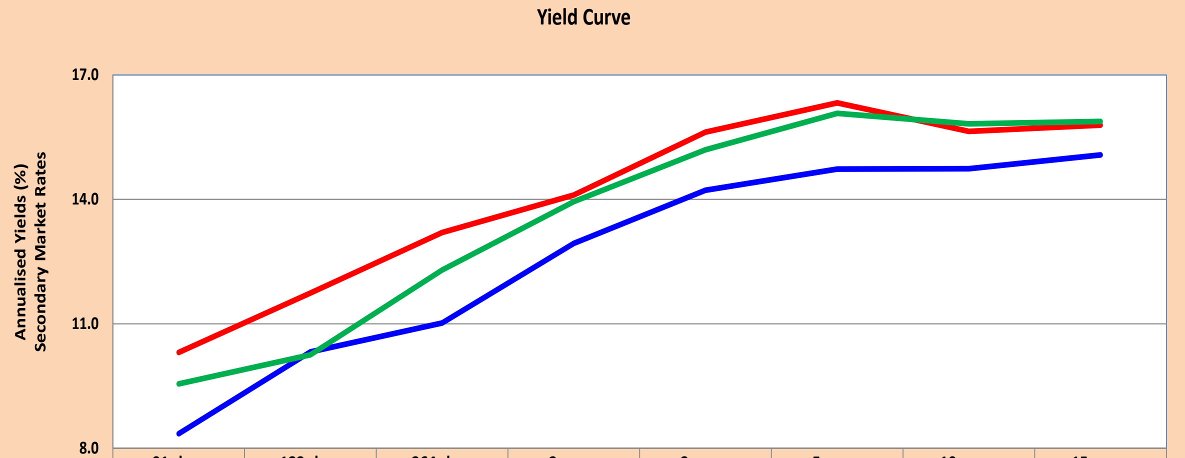
Source: Bank of Uganda

3.2.3.2 Yields on Government securities

Yields on Government securities declined in April and May 2020, having risen substantially in January 2020. At the short end, the yields on the 91-day and 364-day Treasury bills declined to average 9.3 percent and 12.6 percent, respectively, in April and May compared to 9.7 percent and 13.6 percent in January 2020. The yields on the 2-year Treasury bonds also declined though marginally from an average of 14.1 percent in January 2020 to 14.0 percent in April and May 2020, while the yields on the 5-year and 15-year Treasury bonds remained relatively stable at 16.5 percent and 15.5 percent, respectively in the same period.

Notwithstanding the uncertainty around the severity and the persistence of the pandemic, yields remained relatively stable on account of the policy response measures that have contributed to reinforcing confidence in financial markets. However, the planned increase in fiscal financing requirements from Shs. 2.6 trillion in FY 2019/20 to Shs. 3.1 trillion in FY 2020/21 could put upward pressure on the yields going forward, particularly in the first quarter of FY 2020/21. Yields in the secondary market also moved in tandem with developments in the primary market as shown in **Figure 4**.

Figure 4: Secondary Market Yields on T-bills and T-bonds



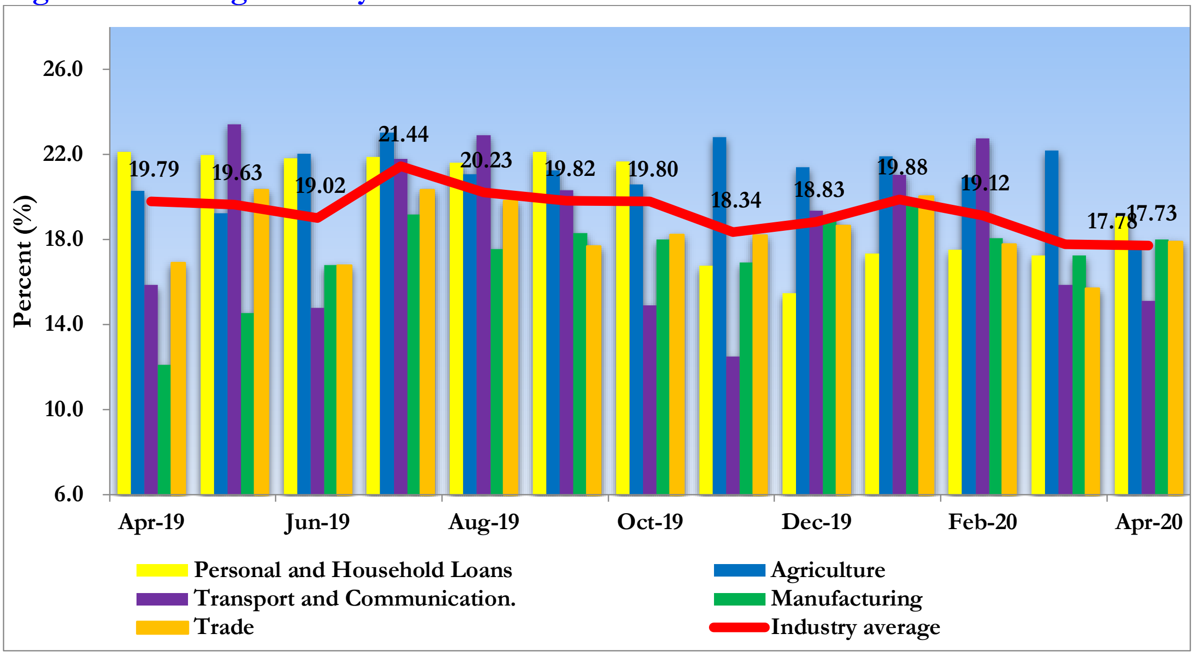
	91-days	182-days	364-days	2-years	3-years	5-years	10-years	15-years
Nov-19	8.4	10.3	11.0	12.9	14.2	14.7	14.7	15.1
Jan-20	10.3	11.7	13.2	14.1	15.6	16.3	15.6	15.8
April/May	9.5	10.2	12.3	13.9	15.2	16.1	15.8	15.9

Source: Bank of Uganda

3.2.3.3 Lending rates

Bank lending to households and businesses remains an important channel through which monetary policy affects the economy. Commercial bank lending interest rates continued to decline in line with the accommodative monetary policy stance. Lending rates on Shilling denominated loans declined to 17.8 percent in March and April 2020, respectively from 19.12 percent in February 2020. Lending rates on foreign currency denominated loans also declined marginally to 6.2 percent and 6.6 percent in March and April 2020, respectively from 6.7 percent in February 2020. The sectoral decomposition of lending interest rates by sector is illustrated in **Figure 5**. Nonetheless, the measures taken by the BoU, including easing financing conditions in the banking sector and the credit relief measures extended to borrowers are yet to take full effect. BoU will continue to maintain an adequate supply of liquidity in domestic markets, to encourage lending by financial institutions to households and businesses. We therefore expect financial institutions to reduce further their lending rates to levels commensurate with our monetary policy stance.

Figure 5: Lending Rates by Sector



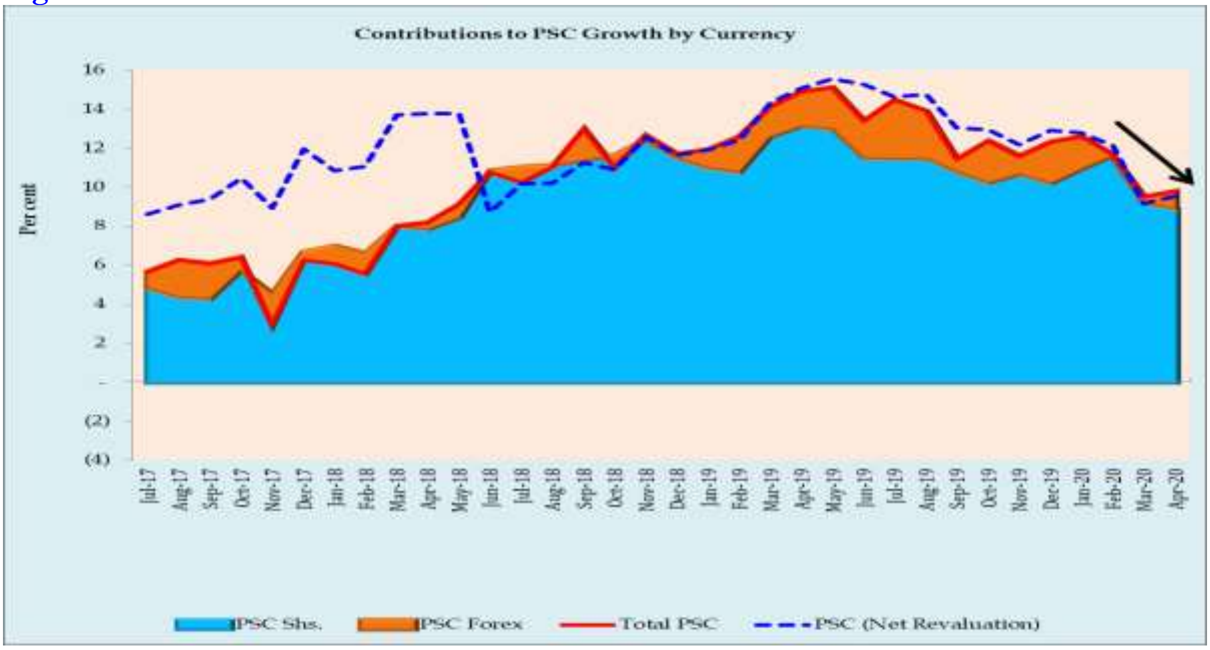
Source: Bank of Uganda

3.2.3 Private Sector Credit and Asset Quality

3.2.3.1 Private Sector Credit

Growth in private sector credit (PSC), a key indicator of financial conditions in the economy has slackened in the recent past. While this trend is evident from July 2019, as shown in **Figure 6**, the decline in the recent past can largely be attributed to the adverse consequences of the covid-19 pandemic on the economy. Indeed, annual growth in PSC declined to single digit levels in March and April 2020. It declined from 11.7 percent in February 2020 to 9.5 percent and 9.8 percent in March 2020 and April 2020, respectively. Specifically, shilling denominated loans grew by 13.9 percent and 13.5 percent, respectively compared to 17.7 percent in February 2020. Foreign currency denominated loans however grew by 1.0 percent and 2.6 percent compared to 0.2 percent during the same period. Net of foreign exchange valuation changes, annual PSC grew by 9.2 percent and 9.5 percent in March 2020 and April 2020, respectively down from 12.1 percent in February 2020.

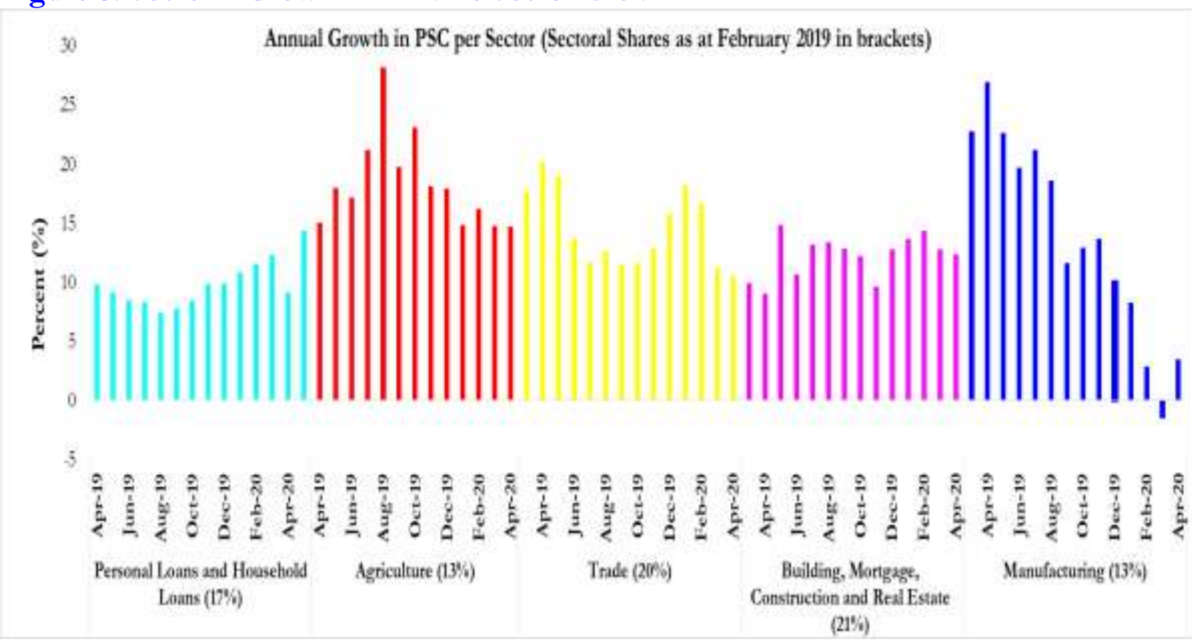
Figure 6: Annual Growth and Contributions to Private Sector Credit



Source: Bank of Uganda

A sectoral decomposition also shows that the growth of PSC to all key sectors of the economy has slackened especially as shown in **Figure 7**. While this slackening can generally be attributed to lethargy economic activity that started in the H2-2019, a decline in the recent past can largely be attributed to the adverse consequences of the COVID-19 pandemic on the economy.

Figure 7: Sectoral Growth in Private Sector Credit

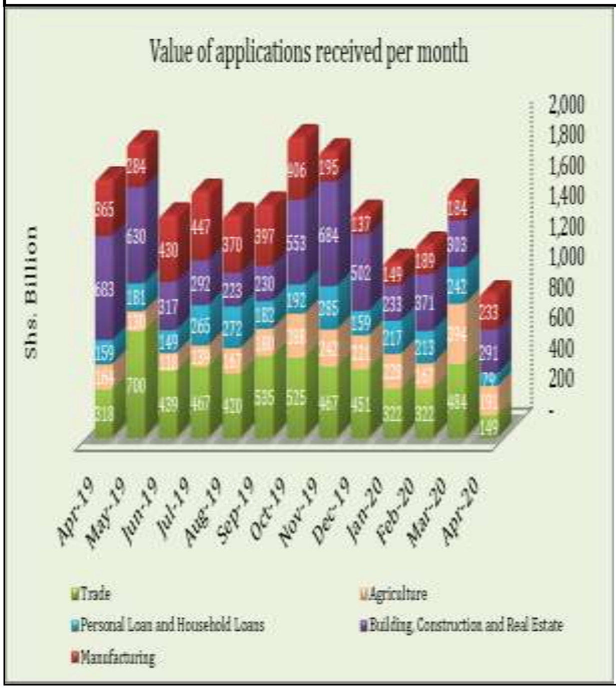


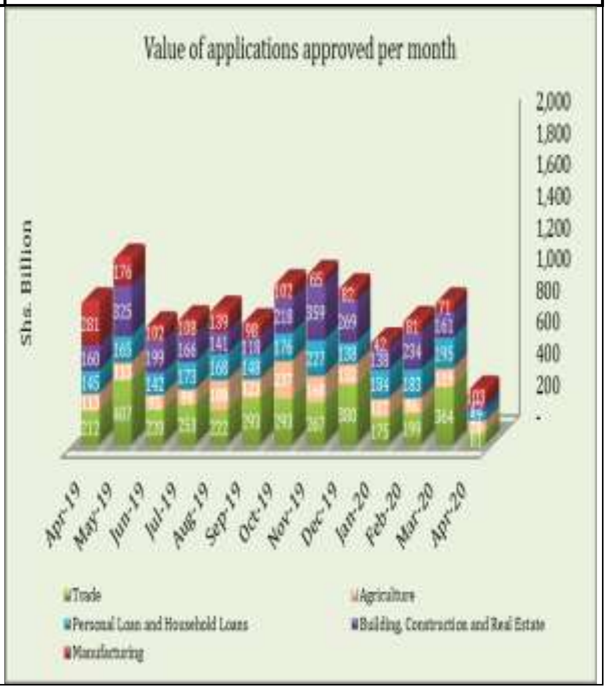
Source: Bank of Uganda

Indeed, the demand for bank credit – proxied by the value of loan applications received - which is largely driven by the level of economic activity has declined significantly during the last four months as shown in the left panel of **Figure 8**. The high value of loan applications in March 2020 was largely driven an increase in the value of loan applications for the trade and personal & household sectors. The value of the approved loans remained substantially below the value of loans applied for in April 2020, which suggest not only tight credit conditions but also the likely absence of credit worthy customers.

Figure 8: Proxies for Demand and Supply of Bank Credit

Value of loan applications received	Value of loan applications approved





Source: Bank of Uganda

3.2.3.2 Asset quality

The ratio of non-performing loans (NPLs) to total loans is the most critical measure of asset quality as loans typically comprise a majority of banks' assets and carry the greatest amount of risk to bank capital. Asset quality in the banking system as measured by the ratio of NPLs to total loans deteriorated further to 5.4 percent in the quarter to March 2020 from 4.7 in December 2019. The increase in NPLs was particularly significant in the agriculture, electricity and water and the personal and household sectors as shown in **Table 3**. The NPL ratio in the agriculture sector remains the highest amongst the key economic sectors, which could in part be explained by the risky nature of agricultural lending.

Table 3: Non Performing Loans by sector

	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
AGRICULTURE	9.8	7.9	9.7	9.1	8.4	7.8	9.8
MINING & QUARRYING	4.7	0.4	0.3	0.8	0.3	0.3	0.1
MANUFACTURING	1.9	2.3	2.9	2.7	2.0	2.4	2.4
TRADE & COMMERCE	6.3	4.0	3.6	3.2	5.0	7.5	7.4
TRANSPORT & COMMUNICATION	4.3	2.6	1.5	3.4	3.8	2.9	2.1
BUILDING, CONSTRUCTION & REAL ESTATE	3.9	2.2	2.5	3.0	4.4	4.5	4.4
ELECTICITY & WATER	0.1	0.0	0.1	0.3	0.1	0.1	30.9
BUSINESS SERVICES	3.7	2.7	3.1	2.8	2.7	2.7	2.9
COMMUNITY, SOCIAL AND OTHER SERVICES	3.8	3.0	8.0	7.6	5.7	5.4	2.2
PERSONAL AND HOUSEHOLD LOANS	3.3	2.6	2.8	2.6	2.7	2.8	4.0
OTHER ACTIVITIES	21.8	8.6	6.7	4.0	17.0	5.0	6.8
OVERALL NPL RATIO	**4.7**	**3.4**	**3.8**	**3.8**	**4.4**	**4.7**	**5.4**

Source: Bank of Uganda

The deterioration in asset quality was attributed to the slackened economic activity that impeded borrowers' ability to service their debts owing to reduced incomes during the lockdown period. Going forward, the economic downturn arising from Covid-19 is expected to increase NPLs further, but this effect will be moderated by the BOU credit relief measures. NPLs are forecast to rise to a range of 6.1 percent to 12.3 percent between June 2020 and December 2020. Banks have become risk averse and responded by reducing lending, driven by concerns about asset quality as well as significant uncertainty about economic recovery.

3.3 Fiscal Developments

3.3.1 Fiscal Operations

Fiscal operations during the first ten months of FY 2019/20 were less expansionary than programmed. The implementation of the budget was constrained by a shortfall in domestic revenue, lower than target financing and the slow execution of infrastructural projects. While the shortfall in revenues can generally be attributed to the less than programmed growth, the less than optimal revenue performance since March 2020 is largely a reflection of the adverse consequences of the pandemic on the economy. Indeed, total Government revenues (including grants) in the ten months of FY2019/20 amounted to Shs. 15,048.7 billion, which was Shs. 3,128.8 billion lower than the approved budget. Grants amounted to Shs. 662.9 billion, which was Shs. 893.9 billion lower than programmed; while domestic revenue amounted to Shs. 14,385.8 billion, which was Shs. 2,234.8 billion lower than the approved budget (**Table 4**). Due to the shortfall in revenue, government indebtedness to BoU amounted to Shs. 2.77 trillion as of 16th June 2020. However, if government fails to repay by 30th June 2020, it will be a violation of the Public Finance Management (PFM) act.

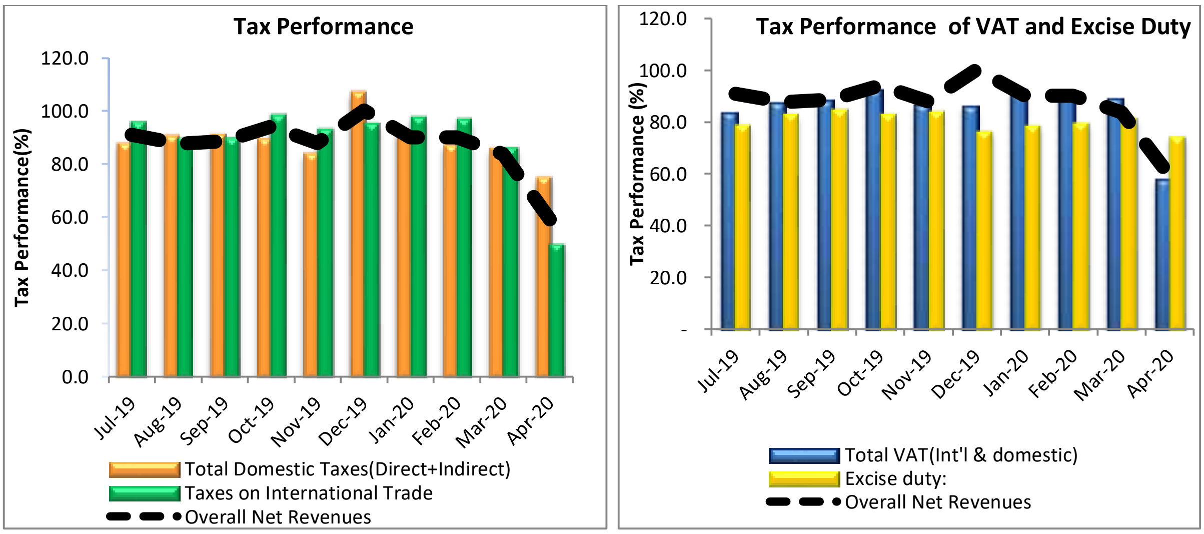
Table 4: Fiscal Operations (Shs. Billion)

	July'18-Apr'19	Preliminary July'19-Apr'20	Approved Budget July'19- Apr'20	Variation
Revenue & Grants	14,502.6	15,048.7	18,177.5	-3,128.8
Revenue	13,481.4	14,385.8	16,620.7	-2,234.8
Grants	1,021.2	662.9	1,556.8	-893.9
Expenditure & Lending	19,947.8	22,014.6	27,572.8	-5,558.3
Current Expenditure	10,386.0	12,008.3	12,509.3	-501.0
Development Expenditure	7,915.8	9,629.3	13,823.8	-4,194.5
Net lending/repayments	1,274.3	55.4	790.2	-734.9
Domestic arrears repayment	371.6	321.6	449.5	-127.9
Deficit (excluding grants)	-6,466.4	-7,628.7	-10,952.2	3,323.4
Deficit (including grants)	-5,445.2	-6,965.8	-9,395.3	2,429.5
Financing (net)	5,445.2	6,965.8	9,395.3	-2,429.5
External Financing (net)	2,717.8	3,013.8	5,753.0	-2,739.2
Domestic Financing (net)	1,587.6	3,672.5	3,642.3	30.2
Errors & Omissions	1,139.8	279.5	0.0	

Source: Ministry of Finance, Planning and Economic Development

Both domestic and international trade taxes were below target, with drastic declines especially in April 2020 as can be seen from the left panel of **Figure 9**. Domestic taxes were 74.5 percent of target, while taxes on international trade were just 49.5 percent of target, largely driven by the considerable decline in imports in April 2020. In the right hand panel, the performance of value added tax (VAT), which is largely a consumption tax, declined to 57.5 percent of target. This largely reflects the fall in consumption and aggregate conditional on the lockdown measures instituted to contain the pandemic. The performance of excise duty - which is largely a production tax – also declined in April 2020 relative to the previous months.

Figure 9: Trend of Tax Performance



Source: Ministry of Finance, Planning and Economic Development

Government expenditure amounted to Shs. 22,014.6 billion, which was Shs. 5,558.3 billion, lower than the programmed expenditure, mainly on account of the underperformance of development expenditure. The developments in government revenue and expenditure resulted in a fiscal deficit of Shs. 6,965.8 billion, which was lower than the programmed deficit by Shs. 2,429.5 billion.

3.3.2 Public Debt

The provisional total public debt stock as at end April 2020 stood at Shs. 53,697.6 billion, an increase of about 13.7 percent relative July 2019. The ratio of debt as a percentage GDP stood at 39.1 percent in nominal value terms as at end April 2020 and 29.7 percent in present value terms, as at end March 2020. The recent loans acquired during the COVID-19 pandemic could possibly push the ratios up in part also due to weaker fundamentals, including slower growth, exchange rate depreciation, weaker exports and a fragile domestic revenue base.

External debt continues to be the dominant component of public debt, accounting for 68.4 percent, while domestic debt accounts for 31.6 percent. Although most of the external debt is from multilateral creditors, there has been a significant increase in semi-and non-concessional borrowing, in part reflecting increased borrowing from bilateral lenders, particularly China. Indeed, the share of multilateral debt declined from 90 percent of total external debt in FY 2010/11 to 63.4 percent in April 2020, while the share of non-concessional borrowing from China rose from 3.3 percent to 23.6 percent over the same period. This non-concessional borrowing, however, is more costly and carries more risks.

While Uganda remains at low risk of debt distress, significant vulnerabilities are evident. Given the rise in debt levels, there is a growing concern of risk to debt distress. One measure used is the ratio of debt-to-tax revenue. This ratio measures liquidity risk and captures the ratio of domestic revenue that is used to service public debt. Based on the joint IMF / World Bank low income countries (LIC) debt sustainability framework (DSF), the threshold for external debt to revenue is 23 percent. As depicted in **Table 5**, debt service as a share of government tax revenue has risen drastically in the recent past. Indeed, Uganda's debt service has surpassed the threshold level in FY2019/20 and it is projected to remain high in FY2020/21. This could be an early indication for fiscal risk that could lead to high levels of debt distress.

Although the multilateral creditors have put in place facilities to dampen the adverse effects of the COVID-19 pandemic, uncertainties relating to the ensuing expenditure pressures, subdued economic activity and declining tax revenues, and a possible further decline in grants could lead to further borrowing on non-concessional terms. The associated increase in interest payments will be a substantial drain on resources that could have otherwise been used to finance development.

Table 5: Debt Service and Interest Payments

As a % of Total Tax revenues	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
Interest payments	15.2	18.9	16.1	15.6	22.7	20.0	19.7	18.2	16.9	16.0
Debt service	18.1	21.9	21.8	23.0	27.3	26.1	27.6	29.0	27.6	27.5

Source: Ministry of Finance, Planning and Economic Development

3.3.3 COVID-19 Stimulus Package

The resource envelop for the FY 2020/21 is Shs. 45,493.7 billion. The revenue target is Shs. 21,810 billion, which translates to 14.3 percent of GDP. To achieve this target, the government is not only expected to broaden the tax base through digitization and use of electronic fiscal devices, but also improve tax administration. The government has also announced a package of fiscal policy measures in the FY 2020/21 budget aimed at resuscitating the economy from the adverse consequences of the COVID-19 pandemic. These initiatives broadly include:

(iv) **Tax relief to businesses:** the government will defer payment of corporate tax income or presumptive tax for corporations and small and medium enterprises (SMEs); and will also defer the payment of PAYE until September 2020 by sectors most severely affected by COVID-19 pandemic such as manufacturing, tourism and floriculture. In addition, government has waived interest on tax arrears, provide for tax deductibility of donations for coronavirus response and will expedite payment of outstanding VAT refunds.

(v) **Restoring household incomes and safeguarding jobs**: government will enhance the provision of improved agricultural inputs using the NAADs; create jobs for the vulnerable but able bodied persons affected by the coronavirus by extending labour intensive public works in urban and peri-urban areas; provide rainwater harvesting technologies in rural communities; roll-out regional and community based storage facilities; provide seed capital to organised special interest groups under the Youth Fund, Women Entrepreneurship Fund and the "Emyooga" talent support scheme.

(vi) **Re-igniting business activity:** government will provide credit through SACCOs and Micro Finance Institutions to support Micro and Small-Scale Enterprises; increase access to credit by providing Shs. 1.045 trillion over the medium term to Uganda Development

Bank (UDB) to offer low interest financing; expedite the payment of domestic arrears.

The government has also committed to enhance economic infrastructure by undertaking emergency maintenance of roads and bridges destroyed by floods, developing warehousing capacity to restore supply chains and promote exports, expediting construction of priority industrial parks and special economic zones, rehabilitating the meter gauge railway and improving water transport safety. The fiscal policy measures, together with the financial and monetary policy measures announced by BoU are expected to enhance the economic recovery in FY 2020/21.

3.4 Balance of Payments and Exchange rates

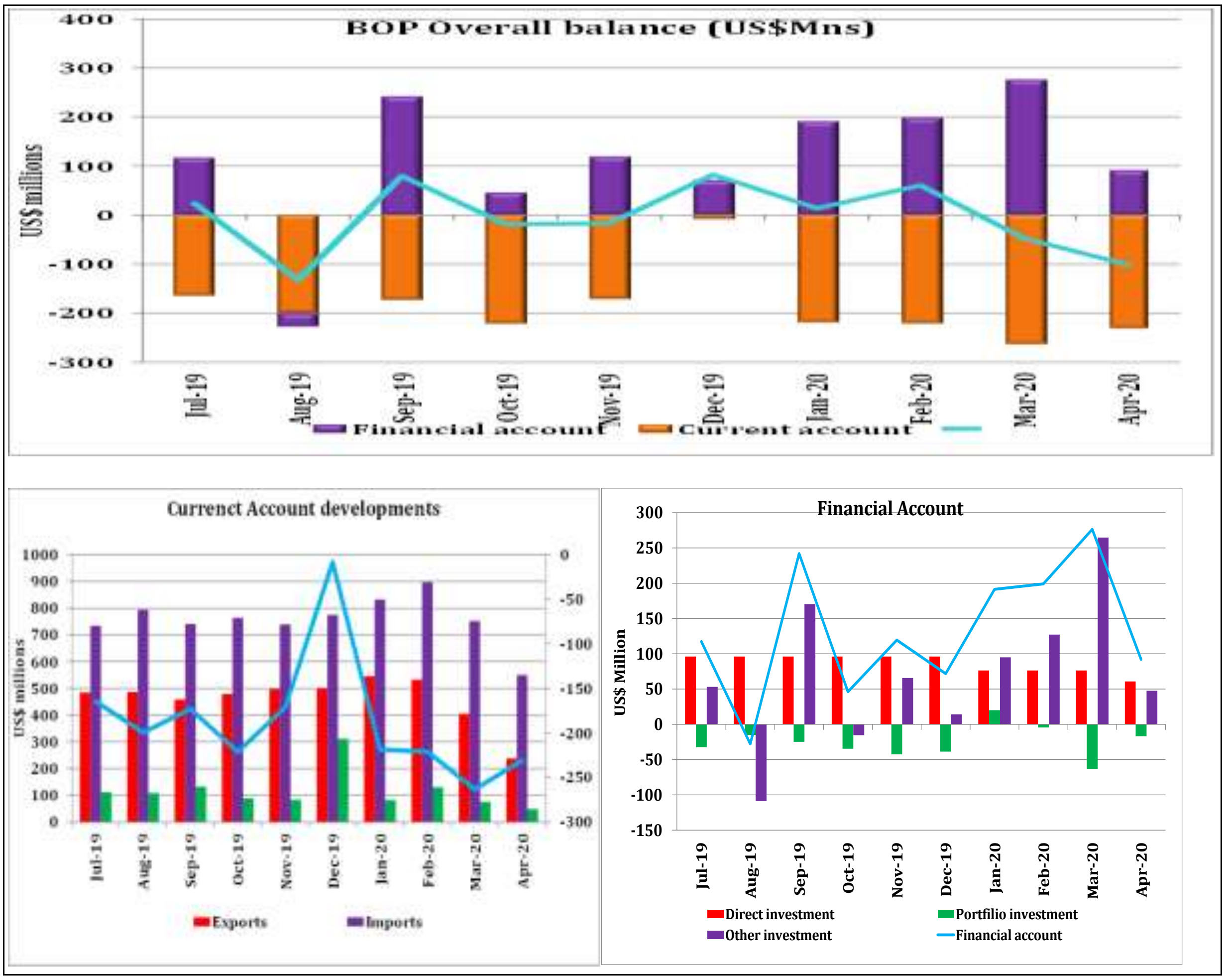
3.4.1 Balance of Payments

The external position was relatively weak in the twelve months to April 2020. The overall balance of payments position was a deficit of US$ 125 million, as the financial account inflows were insufficient to finance the current account deficit (CAD). The CAD however narrowed by to US$ 2,326.9 million compared to a deficit of US$ 2,601.6 million during the twelve months to April 2019. This improvement was mainly driven by a decline in imports, a reduction in investment income and an improvement in private transfers.

The trade deficit narrowed on account of a stronger decline in imports bill, which narrowed by US$231.1 million to US$6,367.4 million on account of a decline in both government and private sector imports. Export receipts also declined by US$ 89.3 million to US$3,841.3 million during the same period. The decline in imports is largely a reflection of subdued domestic economic activity on account of the COVID-19 pandemic that has disrupted international and domestic supply chains.

Private transfers rose by US$238.98 million to US$ 1,963.4million on account of an increase in both remittances and inflows on account of Non-governmental organizations (NGOs) operations. The services deficit however worsened by 61percent (US$407.6 million) on account of an increase in payments to non-residents for other business services and lower inflows though government goods and services. **Figure 10** depicts the evolution of the annual balance of payments.

Figure 10: Developments in Overall Balance of Payment and Main Components



Source: Bank of Uganda

During the 12 months to April 2020, the financial account surplus declined to US$1,767.6 million compared to US$ 2,057.3 million in the preceding period. The deterioration in the financial account surplus was mainly attributed to a decline in foreign direct investment (FDI) and an increase in portfolio outflows. Indeed, FDI declined by US$66million to US$1,096.5 million while portfolio outflows rose by US$129.3 million to US$289.95 million. There was also a build-up in currencies and deposit assets abroad by commercial banks. The stock of reserves at the end of April 2020 stood at US$3,163.6 million, equivalent to 4.6 months of future imports of goods and services.

The external position is however projected to deteriorate further on account of the adverse consequences of the COVID-19 pandemic on the flow of international trade, tourism, workers' remittances, foreign direct investment (FDI) and loan disbursements. Exports earnings for FY 2019/20 are projected to decline by 4.3 percent compared to the initial projections. Likewise, the import bill is projected to decline by 8.2 percent. In the same vein, tourism receipts are projected to decline by 32.4 percent. Personal transfers are however projected to increase by 2.9 percent.

While these developments will reduce the current account deficit from an initial projection of 2,850.8 million to US$ 2,590.1 million, this will be more than offset by the deterioration of the financial account leading to a drawdown of reserves as shown in **Table 5.**

In FY 2020/21, the current account deficit is projected to deteriorate further US$3,853.4 million, driven by a faster recovery in imports amidst subdued export earnings, and a decline in tourism earnings and personal transfers on account of the prolonged adverse consequences of the pandemic. FDI inflows are projected to remain subdued in FY2020/21 while it is anticipated that loan disbursements will pick up as donors provide funding to mitigate the effects of the COVID-19 pandemic. Reserves are expected to further decline from 4.0 future months of imports in FY 2019/20 to about 3.2 future months of imports by the end of FY2020/21. Details of the BoP projections are depicted in **Table 6.**

Table 6: Balance of Payment Projections- US$ million

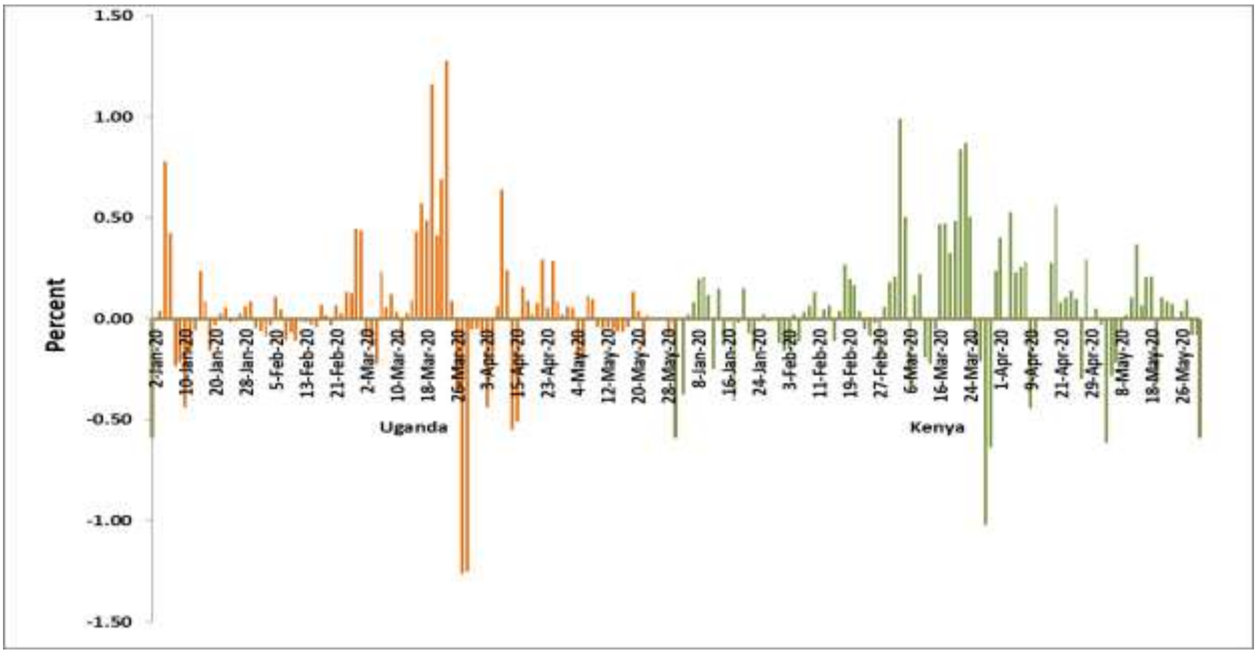
Item (in US$ million unless Stated otherwise)	FY 2019/20 (Initial Projection)	FY 2019/20 (Current Projection)	Percentage Change	FY 2020/21 (Current Projection)	Percentage Change
Current account	-2,850.8	-2,590.1	-9.1	-3,835.4	48.1
Exports	3,696.5	3,536.6	-4.3	3,566.4	0.8
Imports	6,396.3	5,871.8	-8.2	6,431.1	9.5
Travel Credits (Tourism)	1,209.0	817.6	-32.4	171.7	-79.0
Personal transfers	1,153.5	1,186.5	2.9	550.8	-53.6
FDI	1,184.0	988.2	-16.5	858.2	-13.2
Loan Disbursements	2,153.9	1,126.2	-47.7	2,495.0	121.5
Reserves	4.2	4.0		3.2	

Source: Bank of Uganda

3.4.2 Exchange Rate Developments

After heightened depreciation pressures in March 2020 largely driven by market sentiments and panic on account of the uncertainty created by the COVID-19 pandemic which led to exit of offshore investors, speculative tendencies and the usual demand for dividend payments from manufacturing, the shilling remained relatively stable in April and May 2020. The demand for foreign exchange was subdued partly driven by low imports and a slowdown in economic activity. In May 2020, the shilling depreciated marginally by 0.15 percent month-on -month and 0.69 percent year-on- year to an average mid-rate of Shs.3,791.5/USD. On the regional front, the Kenya Shilling and Uganda Shilling experienced some volatility during the three months to April 2020 before stabilising in May 2020 as depicted in **Figure 11** below.

Figure 11: Daily Changes in Exchange rates



Source: Bank of Uganda and Central Bank of Kenya

Going forward, the exchange rate is expected to remain relatively stable in the short run. However, in the medium term, depreciation pressures could emerge with a worsening current account deficit.

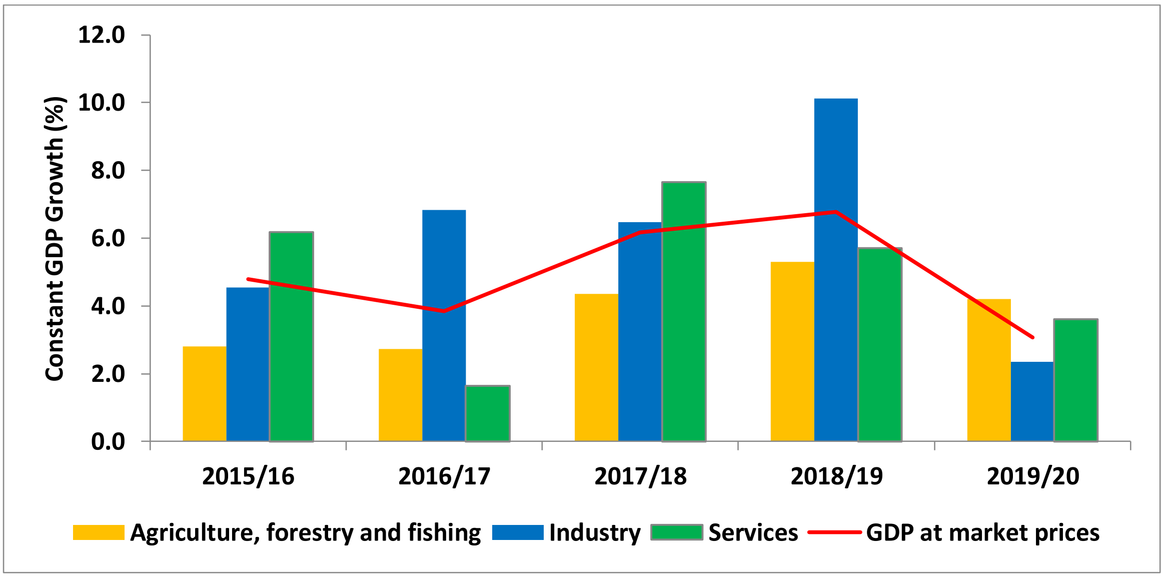
In terms of purchases for reserve build-up contingent on conditions in the interbank foreign exchange market (IFEM), BoU has so far purchased US$ 744.70 million. Taking into account the intervention sales amounting to US$ 219.65 million and targeted sales to Uganda Electricity Transmission Company Limited (UETCL) of US$104.79 million , the net BoU action in the IFEM was a purchase of USD 420.26 million.

3.5 Domestic Economic Activity

In April 2020, BoU projected that GDP growth for FY 2019/20 would decline to the range of 3 - 4 percent on account of the adverse effects of the COVID-19 pandemic. Indeed, in the recent preliminary estimates, the Uganda Bureau of Statistics (UBOS) projects the GDP growth FY 2019/20 to have growth slowed down to 3.1 percent compared to a growth rate of 6.8 percent in FY 2018/19. Moreover, the quarterly GDP estimates indicate that most of the growth was achieved in the H1, as the annual growth in the first 2 quarters FY 2019/20 averaged 3.3 percent.

Economic growth was largely driven by the improvement in the agriculture sector, which grew by 4.2 percent, largely on account of good weather conditions and productivity gains from public investment in the agricultural sector. Growth in the services sector declined to 3.6 percent from 5.7 percent realised in FY 2018/19. The growth in the services sector was largely driven by the robust growth in Information and Communications, Administrative and Support Service Activities, and Public Administration. Activity in most of the other services sectors declined on account of the adverse effects of the pandemic. Industry grew by 2.3 percent compared to a growth rate of 10.1 percent realised in FY 2018/19. This growth was largely driven by the performance of Electricity, Water and Construction sub-sectors; as the performance of Manufacturing and Mining & quarrying was dismal. The sectoral performance of GDP is shown in **Figure 12**.

Figure 12: Constant Real GDP Growth



Source: Uganda Bureau of Statistics

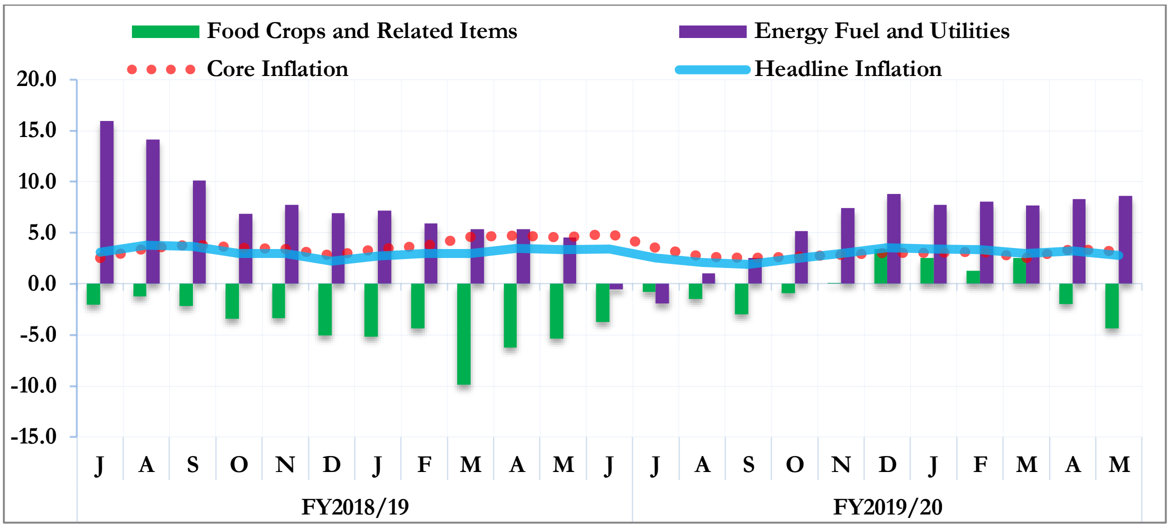
Although Uganda is gradually easing the lockdown measures instituted to contain the spread of the pandemic, the adverse consequences of the global and domestic supply chain disruptions could persist through the remaining part of 2020. Accordingly, BoU has revised down its projection of economic growth to a range of 2.5 to 3.5 percent in 2020 from the April 2020 forecast of 3 to 4 percent. Despite the economic slowdown in 2020, a gradual recovery is expected to set in during the third and fourth quarters. BoU therefore projects that the economy will expand by 4 - 5 percent in 2021, increasing further to 6 - 6.5 percent in 2022. The output gap is expected to remain negative over the entire forecast horizon and will close only gradually. The strength of the economic recovery will depend in part on how Uganda will be able to open up for economic activity safely, and in particular how effectively the public will comply with social distancing rules. Resumption of pre-pandemic levels of economic activity will be gradual, partly due to dampened external demand amidst the deterioration in global economic sentiment.

3.6 Consumer Price Inflation

3.6.1 Recent Inflation Developments

Inflation remained relatively subdued with annual headline and core inflation declining to 2.8 percent and 3.2 percent, respectively in May 2020. During the last 12 months, annual headline and core inflation has averaged 3.0 percent and 3.3 percent, respectively. Food crops inflation also remains subdued, declining further to *minus* 4.4 percent in May 2020. On the other hand, annual Energy, Fuel and Utilities (EFU) inflation edged-up by to 8.6 percent in May 2020 from 8.3 percent in April 2020. EFU inflation has remained relatively elevated, averaging 7.7 percent since October 2019, mainly driven by a rise in the solid fuels inflation, particularly charcoal. The details of the developments in domestic inflation are shown in **Figure 13**.

Figure 13: Domestic Inflation Developments

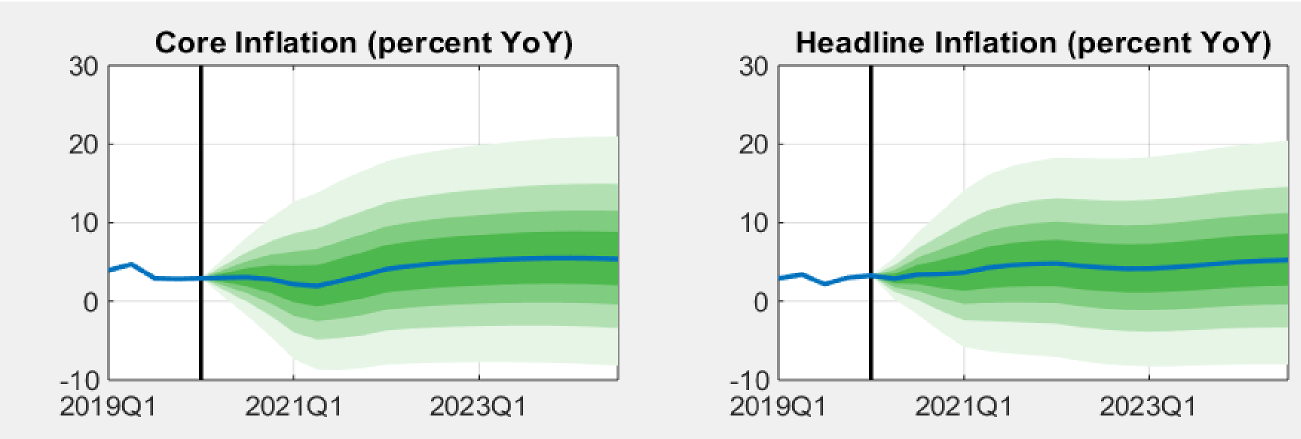


Source: Uganda Bureau of Statistics (UBOS)

3.6.2 Inflation Outlook and Risks

Consistent with the slowdown of economic activity, inflation had remained subdued. The public transport measures to contain the pandemic will temporally increase transport costs in months ahead but the overall risks to the inflation outlook appear to be to the downside. The economic slowdown and a gradual recovery will keep inflation below the medium-term target of 5 percent in the near term (12 months ahead). Inflation however is forecast to return to the target in the medium term (2-3 years). Moreover, external sources of inflation are likely to remain weak in the near term amid the global economic downturn and food crop inflation is also expected to remain contained. Risks to inflation from shilling depreciation are expected to stay low as pass-through of exchange rate depreciation to inflation is expected to remain slow due to subdued demand. The inflation forecasts are depicted in **Figure 14**.

Figure 14: Inflation Outlook



Source: Bank of Uganda

4 Conclusion and Policy Implications

The COVID-19 pandemic continues to have adverse effects on the economy. Since the April 2020 Monetary Policy Committee (MPC) meeting, the pandemic continues to spread with wide-ranging social and economic effects. The recent preliminary estimates by the Uganda Bureau of Statistics (UBOS) projects that GDP growth slowed down to 3.1 percent in FY 2019/20 down from 6.8 percent in FY 2018/19. Growth was largely driven by the improvement in the agriculture sector, which grew by 4.2 percent. The services and industrial sectors were relatively subdued, growing by 3.6 percent and 2.3 percent, respectively.

Although Uganda is gradually easing the lockdown measures instituted to contain the spread of the pandemic, the adverse consequences of the global and domestic supply chain disruptions could persist through the remaining part of 2020. While the economic slowdown will be severe in the second quarter of 2020, a gradual recovery is expected to set in during the third and fourth quarters. On the whole, household expenditure, investment, exports and imports are projected to decline in 2020. Accordingly, BoU has revised down its projection of economic growth to a range of 2.5 to 3.5 percent in 2020 from the April 2020 forecast of 3 to 4 percent. BoU however projects that the economy will expand by 4 - 5 percent in 2021, increasing further to 6 - 6.5 percent in 2022. The output gap is expected to remain negative over the entire forecast horizon and will close only gradually. The strength of the economic recovery will depend in part on how Uganda will be able to open up for economic activity safely, and in particular how effectively the public will comply with social distancing rules. Resumption of pre-pandemic levels of economic activity will be gradual, partly due to dampened external demand amidst the deterioration in global economic sentiment.

The combination of the COVID-19 pandemic, extreme weather, and volatility in the global financial markets, could weigh-down Uganda's balance of payments, potentially destabilizing the domestic foreign exchange market and dampen economic growth. Nonetheless, after heightened depreciation pressures in March 2020 largely driven by market sentiments and panic on account of the uncertainty created by the COVID-19 pandemic which led to exit of offshore investors, speculative tendencies and the usual demand for dividend payments from manufacturing, the shilling remained relatively stable in April and May 2020. The demand for foreign exchange was subdued partly driven by low imports and a slowdown in economic activity. In May 2020, the shilling depreciated marginally by 0.15 percent month-on -month and 0.69 percent year-on- year to an average mid-rate of Shs.3,791.5/USD. Going forward, the exchange rate is expected to remain relatively stable in the short run largely on account of muted import demand. However, in the medium term, depreciation pressures could emerge with a worsening current account deficit.

On the positive side, the BoU's decisive easing of liquidity conditions in the banking system influenced the decline of average lending rates to 17.7 percent in April 2020 from 19.9 percent in January 2020. Also, the forthcoming fiscal stimulus together with accommodative monetary policy might offset the negative impact the COVID-19 pandemic has on the economy in a manner that is stronger than currently envisaged.

Consistent with the slowdown of economic activity, inflation had remained subdued. The headline and core inflation declined to 2.8 percent and 3.2 percent, respectively, in May 2020, from corresponding levels of 3.2 percent and 3.4 percent in April 2020. The public transport measures to contain the pandemic will temporally increase transport costs in months ahead but the overall risks to the inflation outlook appear to be to the downside. The economic slowdown and a gradual recovery will keep inflation below the medium-term target of 5 percent in the near term (12 months ahead). Moreover, external sources of inflation are likely to remain weak in the near term amid the global economic downturn and food crop inflation is also expected to remain contained. Risks to inflation from shilling depreciation are expected to stay low as pass-through of exchange rate depreciation to inflation is expected to remain slow due to subdued demand.

Although the measures taken by the BoU are yet to fully work to mitigate the adverse impact of the pandemic on the economy, it is necessary to ease financial conditions further since inflation outlook remains benign. Accordingly, BoU further eased monetary policy, reducing the CBR by 1 percentage point to 7 percent. The band on the CBR was also reduced by 1 percentage point to +/-2 percentage points, while the margin on the rediscount rate and bank rate were set at 3 and 4 percentage points on the CBR, respectively. Consequently, the rediscount rate and the bank rate were reduced to 10 percent and 11 percent, respectively.