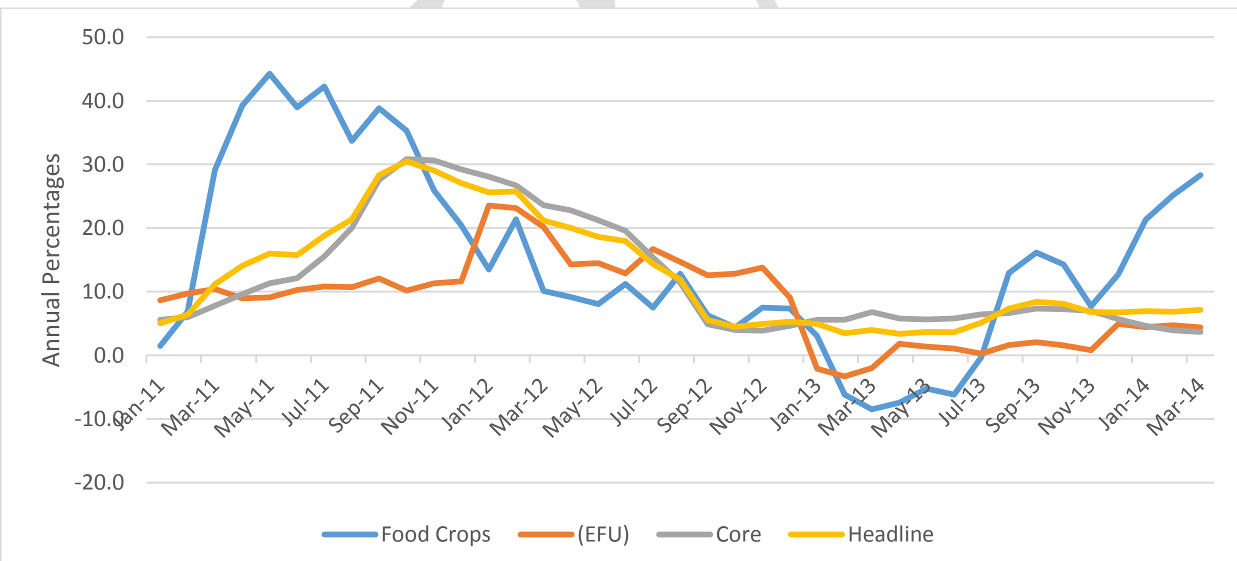
Financial Sector Regulation: Is this the missing link to achieve low & stable inflation and still have low lending rates?

The inflation outturns for March 2014, as noted in the Monetary Policy Statement for April 2014, indeed give a mixed signal. The annual headline inflation was 4% in March 2013 but was 7.1% in March 2014 representing a 77.5% increase. Whereas the annual core inflation was 3.7% in the March 2013, it turned out at 6.8% in March 2014, a 45.6% reduction since the same period last year. The food crops prices, however, had a more profound percentage increase in the same period last year. In March 2013, the annual food crop inflation was -8.5% but turned out at 28% in March 2014, a 432.9% increase. This, again as noted in the MPS, goes to confirm CSBAGs earlier concerns about the importance of controlling food prices.

Figure 1: Annual Inflation trends in Uganda from January 2011 to March 2014



Source: Bank of Uganda

From the MPS for April 2014, we note the following;

- Annual core inflation is forecast to increase over the next twelve months to a range of 6-7% by April 2015,

- Economic growth is still projected at 6% and 6.5% in the FY 2013/14 and 2014/15 respectively.
- Economic growth in the FY 2013/14 could be hampered by weakness in credit growth and net exports.

Based on the above outlook, the Bank of Uganda (BOU) chose to keep the Central Bank Rate (CBR) at 11.5%, a neutral monetary policy stance.

We would like to appreciate the response that the BOU gave to the January response to the Monetary Policy Stance shared by CSBAG. In as much as there is no question as to the success of the BOU containing the inflation in Uganda, we still seek to see the use of tools that have the desired impact not only on inflation but on the economy as a whole. This is because the tools adopted have profound effects on the economy as a whole. To note is the projected Gross Domestic Product (GDP) growth of 6% for the FY 2013/14 which was thought to be 7.4% according to the National Development Plan 2010/11 – 2014/15 (NDP). The GDP for the FY 2014/15 is now projected to be 6.5% far from the NDP guidance of 7.5%. The reasons acknowledged by the BOU for the even lower GDP growth in the FY 2013/14 have a great deal to do the impact of the high lending rates that in turn weaken the credit growth.

The indicator for the reduced lending rates is a weighted average that for the most part leaves out layers that are used by the commercial banks. In March, the average lending rates as recorded by the BOU was 20.8%. When we, however, took the liberty to ask for lending rates from ten leading commercial banks, none of them had a lending rate lower that 25% to offer, some were engaged in predatory and discriminatory lending. This was for products that should be ideally accessed by the common working Ugandan earning UGX 750,000/= so that he can get capital to start up a business. Please note that when we say a Ugandan who earns UGX 750,000/= we have put the bar so high since more than half of the working population doesn’t earn anything close to that. According the UBOS HH survey in 2009/10, the average income per month is UGX 37000/=. This goes to illustrate the extent to which the majority of Ugandans are discriminated against by the banking system. According to the FINSCOPE III Survey 2013, 46% of the adult population has no access to formal financial institutions.

In his discussion during the 20th Joseph Mubiru Memorial lecture, Professor Stiglitz likened the financial sector to the brain of the economy. That it is central to the management of risk and the allocation of capital. It runs the economy’s payment mechanism. It intermediates between savers and investors, providing capital to new and growing businesses. When it does its functions well, economies prosper, when it does its jobs poorly, economies and societies suffer.

When we ask for BOU to regulate the commercial banks further we do not propose that the central banks decides the lending rates for each of the 26 banks but at the same time moral persuasion has not yielded the desired results for the past 24 months. The same commercial banks that have been operating the economy with financial bottle necks only seemed to respond to the CBR when it implied an increase in the lending rates. Now that it’s time to reduce the lending rates as signaled by the weak monetary policy stance, they recall all the bottle necks in the financial sector as reasons for not lowering lending rates. Commercial banks seem more focused on investing in government bonds or speculating on foreign exchange than providing loans to local enterprises. More recently, they have found it easier to make money lending to consumers than to businesses. They are enjoying the good life, taking in deposits at low interest rates, and relending the money to government, companies (including SMEs) and individuals at high interest rates. This is what made us suggest that the BOU comes in to compel the commercial banks with fines and other reprimands for failure to reduce the lending rates.

The idea that investors will be scared away if BOU tries to further regulate the lending rates is to allow and shelve all sorts of cheats that will come and hide as investors here. This is because banking attracts those that are more motivated by financial rewards, than the intrinsic rewards of public service. Worthwhile investors should follow the rule of law and be able to respect the market and the agencies regulating the markets. Also to note is that these “investors” repatriate a great deal of their income back to their home countries. We need more regulations to oversee the financial sector, to make sure that private incentives are better aligned with social returns. This alignment can’t happen on its own, and it won’t happen on its own. It is only when private rewards equal social returns that markets are efficient, that Adam Smith’s “invisible hand” has any chance of working.

The progressive initiatives adopted by the Bank of Uganda, like financial literacy, financial outreach and consumer protection are those whose impact is hard to measure. In the market where information asymmetry is a real threat, people need to know what is happening and the best suited institution to provide financial information is the BOU. We encourage the BOU to take this effort on more rigorously if we are to see these options work.

Sectors like agriculture that are side-lined by some commercial banks, should receive a mandated portion of the commercial banks total loan portfolio and within a given range of interest rates. This is for the fact that not only will this enhance job creation but also improve the GDP growth for the country. The Bank of Uganda should impose stiff sanctions for commercial banks that deny credit to the agriculture sector.

In a nut shell, as government makes efforts to remove the structural bottle necks to the agriculture sector, the Bank of Uganda through the Monetary Policy can do more to reduce the negative impacts of using the CBR as the policy variable in the Inflation Targeting framework. Specifically we recommend:

- Government should address the supply side shocks in the agriculture sector so that they do not negate the efforts if inflation targeting in achieving the policy target of a low and stable inflation.
- The Bank of Uganda should educate the business community more on the importance of following the indications of the Central Bank Rate (Financial Literacy).

- The Bank of Uganda should deliberately persuade the commercial banks to reduce the lending rates as indicated by the maintained neutral stance, keeping CBR at 11.5%.
- The establishment and capitalization of the agriculture bank should be considered as this will not only provide the much needed credit to the sector that employs 80% of Ugandans but also will enable use of modern agriculture techniques which will shoulders the food supply shocks thus keeping inflation lower and more stable.