THE EXCHANGE RATE DEPRECIATION MARVEL IN UAGANDA.

Understanding Exchange Rate

Exchange rate is the price of a nation’s currency in terms of another currency. It is the rate at which one currency will be exchanged for another. It is also regarded as the value of one country’s currency in terms of another currency. An exchange rate thus has two components, the domestic currency and a foreign currency, and can be quoted either directly or indirectly. In a direct quotation, the price of a unit of foreign currency is expressed in terms of the domestic currency. In an indirect quotation, the price of a unit of domestic currency is expressed in terms of the foreign currency.¹

The Monetary Policy is a framework in which the Central Bank manages money supply to achieve healthy economic growth. The targets of the Monetary Policy in Uganda is to have an inflation rate that is below 5%. However, the Monetary Policy also looks at other variables like the exchange rate, interest rate and Balance of Payments. This is because the both have an impact on the inflation in the country.

Depreciation/appreciation of a currency

A currency is said to be getting stronger or appreciating if that currency is going up in value against another. So $1: UGX 2500 moving to $1: UGX 2800 means the dollar is getting stronger.

A currency that is becoming weaker or depreciating is a currency that is going down in value against another. So $1: UGX 2000 moving to $1: UGX 2700 means the shilling is getting weaker.

Currencies change in value because there is a change in demand for holding that currency. Households, governments and businesses need other countries’ currencies to buy their goods and services such as petroleum products, machinery, travel abroad etc.

A change in exchange rates might affect a business in the following ways:

- Exchange rates changes can increase or lower the price of a product sold abroad. When the shilling depreciates against the dollar, it means that we means that one needs more shillings to buy a unit of a dollar. Therefore, for imports whose purchasing cost was in USD, one needs more shillings to buy them. i.e. goods and services procured form abroad

¹ http://www.investopedia.com/terms/e/exchangerate.asp
in USD become more expensive. The reverse should be true when the shilling appreciates against the foreign currency.

- When the shilling depreciates against the USD, the price of exports that are priced in USD should reduce. This is because one needs less foreign currency for every unit of the shilling. This situation should encourage exports and as such the earnings from exports are supposed to increase. This benefit stands a risk of being weakened by the payout of other factors on the world market and so cannot be relied upon. When the shilling appreciates, the reverse is true for our exports.

**The Uganda Exchange rate situation**

In line with a liberalised current and capital account of the balance of payments, Bank of Uganda pursues a flexible exchange rate policy regime. In this regime, the price of the shilling visa-vi the US dollar and other foreign currencies is determined by the market forces of demand and supply. BOUs involvement in the foreign exchange market is limited to occasional interventions (purchase or sale of foreign currency) only to dampen excessive volatility in the exchange rate. Stable exchange rate movements in either direction (appreciation or depreciation), enables the proper planning by all market players.²

**Figure 1: USD: UGX Depreciation/Appreciation rates – January 2004 to February 2015**

![Rate of change (appreciation/depreciation)](https://www.bou.or.ug/bou/monetary_policy/faqs.html)

**Source: Bank of Uganda Statistics**

Figure 1 above shows a line graph of the monthly Shilling: Dollar depreciation or appreciation trends from the last 10 years. All data points below Zero show that the shilling appreciated against the dollar while the data points in the positive show a depreciation shilling. Over the past ten years, the worst depreciation rate was recorded in October 2008 where the shilling depreciated against the dollar from UGX 1,645 in September 2008 to UGX 1,838.7³ in October 2008 and the rate of depreciation was noted to be 11.8%. A closer look at Figure one shows that the shilling has depreciated most in Q1 and Q3 of the various FYs that fall in the period under

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² [https://www.bou.or.ug/bou/monetary_policy/faqs.html](https://www.bou.or.ug/bou/monetary_policy/faqs.html)
³ Bank of Uganda Statistics
analysis. This trend can be linked to the seasonality of the demand for the USD towards Christmas and Easter holidays as traders’ and other players in the market stock goods and services. Importers and those who wish to travel abroad buy the USD just before the festive seasons so that they do not face the high rate. This development in its self is self-correcting since the shilling appreciates after this period.

The developments witnessed from July 2014 to February 2015 where the shilling has slowly but steadily depreciated against the USD can be explained by a number of reasons with the strongest of them pointing to reduction in the supply of the US dollar on the world market.

**Figure 2: Period Average Exchange rate from January 1990 to February 2015**

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\begin{align*}
\gamma &= -7\times 10^{-19} x^6 + 2\times 10^{-13} x^5 - 2\times 10^{-08} x^4 + 0.0008 x^3 - 21.874 x^2 + 326261 x - 2\times 10^9 \\
R^2 &= 0.9605
\end{align*}
\]

*Source: Bank of Uganda Statistics*

Figure 2 above shows a slow but sure depreciation of the shilling. The Polynomial trend line fit on the data suggests that the exchange rate will be within the UGX 2000 to the UGX 2500 band over the next six months, until August 2015. This outlook of hope unfortunately does not consider the economic fundamentals as it is purely a statistical exercise. To realise the projected exchange rates in the near future, we ought to understand what explains the current depreciation situation and work towards correcting glitches highlighted below.

**What explains the current exchange rate depreciation?**

Situation in figure 1 and 2 can be explained by the a number of issues but specifically the following:

- The ambitious infrastructure programme by the GoU. The Karuma Hydro power Dam Project (600 MW) to cost UGX 1,096 billion\(^4\) in the FY 2014/15, the Isimba Hydro power dam projects (183 MW) to cost UGX 0.9 billion\(^5\) in the FY 2014/15, the standard gauge rail way project and the Oil sub sector investments are having a major impact on

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\(^4\) Approved budget estimates for the FY 2014/15  
\(^5\) Approved budget estimates for the FY 2014/15
the forex market in Uganda. The huge forex requirements by these undertakings in reality or in speculation cannot be sustained by the Uganda’s forex market. Whereas actual expenditure on the dam projects is getting stronger as they kicked off in the FY 2014/15, the economy does not have enough dollar to implement them without shocks like we are witnessing. The equipment required to implement the projects is procured in forex (USD) and so are the payments to the expatriates employed with these projects. The standard gauge railway project has also had major speculative impacts that have too wiped dollars from the economy.

- Strengthening of the US Economy. The other major reason for the depreciation of the shilling is the reduction of supply of the USD on the world market. The combination of higher oil production and lower oil consumption in the United States has already reduced net imports as a share of U.S. liquid fuels use from 60% in 2005 to 40% in 2012. Net import volumes of crude oil and liquid fuels on a volume basis are projected to decline by 55% between 2012 and 2020. What this means for the Ugandan Economy is that there is going to be a continued strain on the supply of USD on the world market. The shilling will potentially continue to depreciate since we heavily rely on the USD for our imports. Purchase of crude oil by the USA has been one of the main mechanisms through which the USD was being injected into the world economy especially to the oil drilling countries particularly in the Middle East. This meant that, other factors constant, where the world exchange rate shortages were supposed to self-correct, they will not because the supply side of the dollar has been tightened. Where Central Banks had reserves of the dollar, they get cautious as to how they intervene in the forex market as they can be certain on how long the supply of the dollar will be constrained.

In another development the U.S. Federal Reserve’s once-in-a-lifetime program to buy immense piles of bonds, month after month, in an extraordinary effort to restart a recession-deadened economy came to an end in October 2014 after adding more than $3.5 trillion to the Fed’s balance sheet – an amount roughly equal to the size of the German economy. The bond-buying program, called quantitative easing or QE, increased the dollar circulation and its sudden end has resulted into reduced supply of the USD.

- Poor performance of Uganda’s Exports.
  In order to increase the dollars inflows in the country, we need to produce for export. Uganda has for a long time now struggled with the question of increasing value from her exports. In the FY 2013/14, the earnings from total exports declined by 6.97%. From the FY 2011/12 in July to the FY 2014/15 in January, the average value of Uganda’s exports is USD 227.83 million. Figure 3 below shows that the exports earnings (in USD) for Uganda have been declining by 0.0038 in the period under review. This implies that value addition is still a very much need concept especially of the coffee that we earn most

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6 [http://www.eia.gov/todayinenergy/detail.cfm?id=15151](http://www.eia.gov/todayinenergy/detail.cfm?id=15151)
8 Bank of Uganda statistics
of the value from (the value of the coffee earnings have reduced consistently from USD 113.29 million in Q3 of the FY 2013/14 to USD 89.94 million in the FY 2014/15.

**Figure 3: Export growth rate from FY 2010/11 Q1 to FY 2014/15 Q2**

![Graph showing export growth rate from FY 2010/11 Q1 to FY 2014/15 Q2. The graph shows a trend line with the equation y = -0.0038x + 0.051.](image)

*Source: Bank of Uganda Statistics*

Where there isn’t an increase in the supply of USD from the exports but the imports are increasing, the forex rate between the shilling and the dollar is tilted against the shilling given the domestic and international play outs highlighted in the first two points.

**Figure 4: Value of Uganda's Exports and Imports from Q1 1993/94 to Q2 2014/15 in USD Millions**

![Graph showing value of Uganda's Exports and Imports from Q1 1993/94 to Q2 2014/15 in USD Millions.](image)

*Source: Bank of Uganda Statistics*

Figure 3 above shows the value of imports well out stripped the value of exports in Uganda over the last 21 years. This means that the shilling will continue to gradually depreciate if the value of Uganda’s Exports does not drastically improve.
The Deteriorating Current Account balance: the Current account measures the inflows and outflows of goods, services and investment incomes. When there is a persistent and large current account deficit, it mean that the value of earned from exports cannot pay for the value need to purchase the imports. More of the local currency then needs to be converted into foreign currency in order to fill the foreign exchange gap needed to import what the country needs. In effect the foreign currency in this case the USD will be getting scarce, with high demand yet the supply is low (from export earnings), causing what is known as depreciation of the local currency.

Figure 5: Current Account balance and Exchange rate from Q3 2001 to Q3 2014

Source: Bank of Uganda Statistics

Figure 4 above shows that in Q3 of 2014 which is also the same as Q2 of the FY 2014/15, the current account balance in for Uganda hit an all-time low of USD 817.36 million¹, not seen in Uganda over the last 13 years. This trend has however been gradual and as the current account deficit grows, so does the exchange rate.

Inadequate regulation of the forex market. In Uganda, there is poor regulation of the flow of forex in and out of Uganda. Uganda is one of the few countries in the world that does not care or have a limit on the amount of forex that can be repatriated, exchanged or held as cash at any one time. Whether this is staged as an incentive for investors or otherwise, it hurts the stock of forex in the country. One can argue that the floating exchange system we are exercising in Uganda will continue to make it hard for the shilling to be stable against the dollar. In South Africa for example, foreign exchange control is applicable to all transactions no matter the size, no resident may effect a transfer without prior approval, no company or legal entity may effect a transfer without prior approval, only authorised dealers are allowed to effect a currency transfer, outward payments may only be made for permissible reasons and under conditions that are approved by the authorised dealers.

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¹ Bank of Uganda Statistics
dealers on behalf of the Reserve Bank, all payments made to foreign parties must be reported to the Reserve Bank, there are set amounts for personal transfers in the form of allowances that must be adhered to. In Ethiopia Non-residents traveling to Ethiopia must declare any/all foreign currency in excess of 3000 USD (or its equivalent in other currency) upon arrival in Ethiopia. These intervention help to keep the integrity of the local currency and make it possible for serious investors to invest in the country.

- Locally registered firms charging for services rendered in foreign currency. The act of charging for services provided in Uganda in USD is worsening the already bad forex situation in Uganda. For as long as the investors, local or international do not value the shilling enough to have it as the medium of exchange in our economy, the forex situation will continue to be bad. This is common in the tourism and service sector to the extent that even local building owners in Uganda ask for rent in USD.

**Recommendations**

- Sequence the infrastructure developments in such a manner that will have limited impact on the real economy.
- Make value addition a major component of GoU projects especially in the agriculture sector. Where the private sector has no capital or know how to add value to the various agriculture sector enterprises that are exported, GoU should intervene directly or indirectly by offering incentivized credit and capacity building sessions as this will increase the value fetched by the same volume of exports. As a result, the supply of foreign currency, particularly the USD will be improved.
- The Bank of Uganda should increase regulation in the Uganda’s forex market. Specifically they should set limits beyond which banks cannot send foreign currency without authorization, among other things.
- But also the bank should reign on local/international entrepreneurs who unnecessarily strain the shilling against the dollar by charging in dollars with no economic justification apart from profit maximization.
- Government should prioritise the implementation of the enterprise zoning that was done for Uganda so as to maximize the productivity of different regions in the country. This will increase production for exports and should work towards improving our earnings from exports.

**Conclusion**

Exchange rate is one of the major variables used by the BoU to manage the Monetary Policy in Uganda, just next to interest rates and inflation. If it is actually true that Uganda holds FOREX reserves of up to 4.2 months of imports, the Bank of Uganda should increase the intervention in the forex market to reduce on the impact of the shilling depreciation shock in real economy. The reduced price of crude oil on the world market will is being countered by the shilling depreciation shock in real economy.

11 [http://ethiopia.usembassy.gov/warden072610.html](http://ethiopia.usembassy.gov/warden072610.html)
depreciation thus making it hard for the common man to realise a reduced price on the fuel pump. This of course potentially spreads into the price of goods and services because not only are major products imported, but they are also transported by road to Uganda. The issues of infrastructure development and value addition are the only concepts that seem to be the ones with the long term solution to the exchange rate question in Uganda, however, in the short run, the BoU needs to sell more USD into the economy to dampen the negative impacts of over depreciation of the shilling.