Inflation in Uganda: How much of it is controlled by the Central Bank Rate[1]?

The annual core and EFU[2] inflation for the month of January 2014 has reduced from 5.7% and 4.9% in December 2013 to 4.6% and 4.4% respectively while the annual food crop and headline inflation rose from 12.7% and 6.7% to 21.4% and 6.9%, respectively. Given that the food crop inflation carries the biggest weight of 27.2% of all the items in the inflation basket, it influenced the annual all item inflation to increase by 0.2%. The monthly inflation percentage changes all declined in January 2014 apart from the food crop inflation that rose by 40% from December 2013.

The monthly decline in headline and core inflation can be attributed to the monthly appreciation of the shilling by 2.1% from December 2013 to January 2014, putting the shilling at UGX 2,475.2; the strongest it has been since June 2012. The impact of restrained demand due to high lending rates, averaging at 22.59% in December 2013, has also been a strong factor in the reduction of inflation in the first half of the FY 2013/14. The reduced demand for goods and services related to unfortunate developments of instability in South Sudan also contributed to downward pressures on domestic inflation, as more exportable goods got stuck in the domestic economy.

The Bank of Uganda (BOU) forecasts that the core and headline inflation will remain the 5-6% range for the first half of 2014. From July 2013 to January 2014, the annual core headline and core inflation have averaged at 7.1% and 6.4%, respectively. So to say that the inflation forecasts for the headline and core inflation will remain the 5-6% range, yet they have not been in that range for the past six months is not statistically correct.

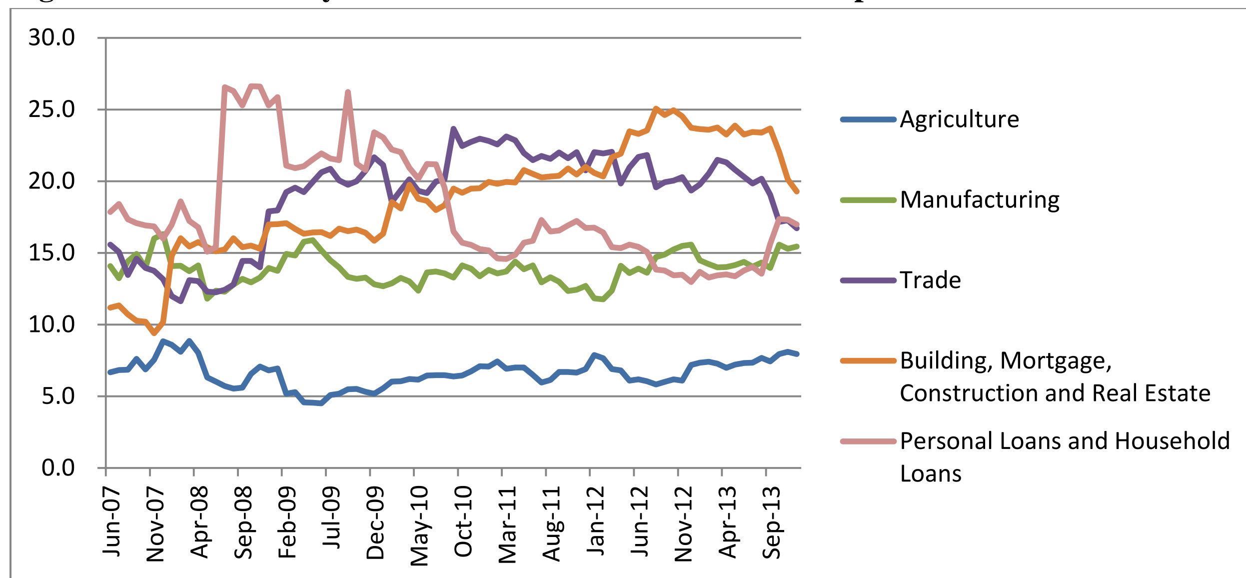
As excess capacity[3] is reduced, the average inflation over the medium term will go way above the target inflation of 5%. This is because the reduction in excess capacity will imply and increase in demand thus demand pull inflation could ensue.

As a negative impact on the private sector by the CBR, the growth in access to credit by the private sector has continued to be strained. This is because the cost of borrowing is high and so

[1] Central Bank Rate
[2] Electricity Fuel and Utilities
[3] Excess capacity means that insufficient demand exists to warrant expansion of output.

becomes a burrier to access to credit. The increase in the credit extension to households reported to be at 38% in December 2013 has no long term good economic implication for the economy. This is because this credit acquired is purely for consumption and not investment. Whether or not CBR is high the demands for consumption still exists and that's why high lending rates are not seen to deter household demand for credit from the commercial banks.

Figure 1: Sectoral analysis of commercial banks' credit to the private sector.



Source: Bank of Uganda

The demand for the credit by households is possibly driven by consumption expenditure such as tuition for school children. These kinds of loans extended to the households are only good looking in the loan portfolio of the commercial banks for a short time. Before long the commercial banks will suffocate from the high rate of bad loans registered. This not only negatively impacts the profitability of the banks but also reduces on the corporate tax levied by URA since it depends on the profits registered by the institution. For as long as the cost of doing business is increased by the high loans administration costs and high rates of non-payment, among other reasons, the lending rates will not go down any further irrespective of how low the Central Bank Rate (CBR) is reduced.

Holding CBR at 11.5% in February 2014 will have no impact on the inflation levels in the economy. Inflation in Uganda, like we have always argued, is not necessarily associated with interest rates thus the use of CBR is only doing more harm than good especially in the real sector, as shown in figure 1. In Kihangire, D and Mugenyi, A (2005), it is shown that fiscal deficit is the single most important factor in explaining Uganda's inflation rate. The elasticity of response was high (+0.65) suggesting that a 100% increase in fiscal deficit is associated with 65% increase in inflation.

The economic growth that is predicted from the growth of house hold credit is not sustainable because the house holds do not have sustainable ways to pay back the loans that they acquire from the commercial banks. Figure 1 above shows that sub sectors like manufacturing, trade, building, mortgage and construction are all reducing in total share to the commercial banks credit. To this extent CSBAG has the following recommendations;

- Maintaining and sustaining sound macroeconomic policies will need to be complemented with other prudent structural policies in order to output and achieve sustainable macroeconomic stability
- Prudent monetary policy, together with a well-coordinated and supportive fiscal policy remains critical in in this respect.
- The full liberalization of interest rates that was done in July 1994 has not had the desired impact on the private sector, especially agriculture. Government should regulate the credit extended to the agriculture sector by fine tuning the Agriculture Credit Facility.
- The Financial Management Reforms by the Ministry of Finance can imply a tight Fiscal Policy and this if maintained will greatly contribute the achieving low inflation in the economy.
- Supportive measures to boost trade remain critical- eradicating non-trade barriers within EAC; and supporting entities to engage in regional trade remain critical aspects in boosting the economy through EAC integration.

References:

Kihangire, D. and Mugenyi, A. (2005). Is inflation everywhere a non-monetary phenomenon? Evidence from Uganda.

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