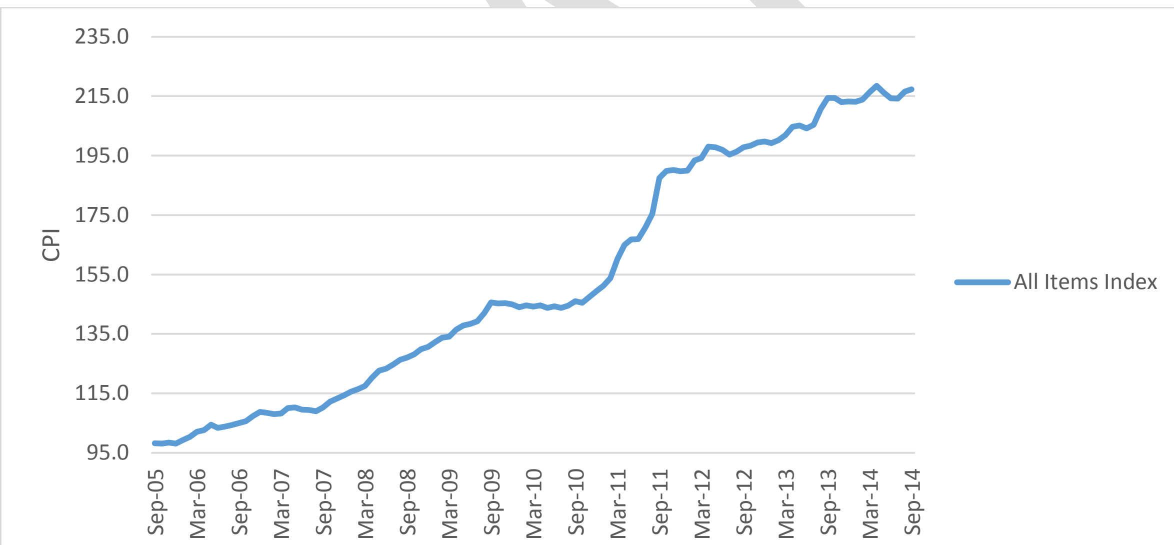
Brief on the Bank of Uganda MPS for October 2014

In the month of September 2014, in headline inflation reduced to 1.4% from 2.8% attained in August 2014. This was the seventh month in a row since March 2014 with headline inflation declining to the current lows. Since March 2014, EFU and Core inflation have had ups and downs while food crops inflation has steadily declined. The CPI for all item index in the base year of 2005/06 was 98.2 in September and in the 2014/15 was 217 for the same period. This means the percentage change in price (inflation) since then is 54.8%; the basket of goods and services that cost UGX 98.2 now costs UGX 217. Whereas this can be explained by a number of factors including increase in domestic demand among others, it shows that the supply side is not in tandem with the demand. This turn out of events shows that the cost of living in Uganda has greatly increased making the issue now the copying mechanisms the main discussion.

Figure 1: CPI trend from July 2005 to September 2014



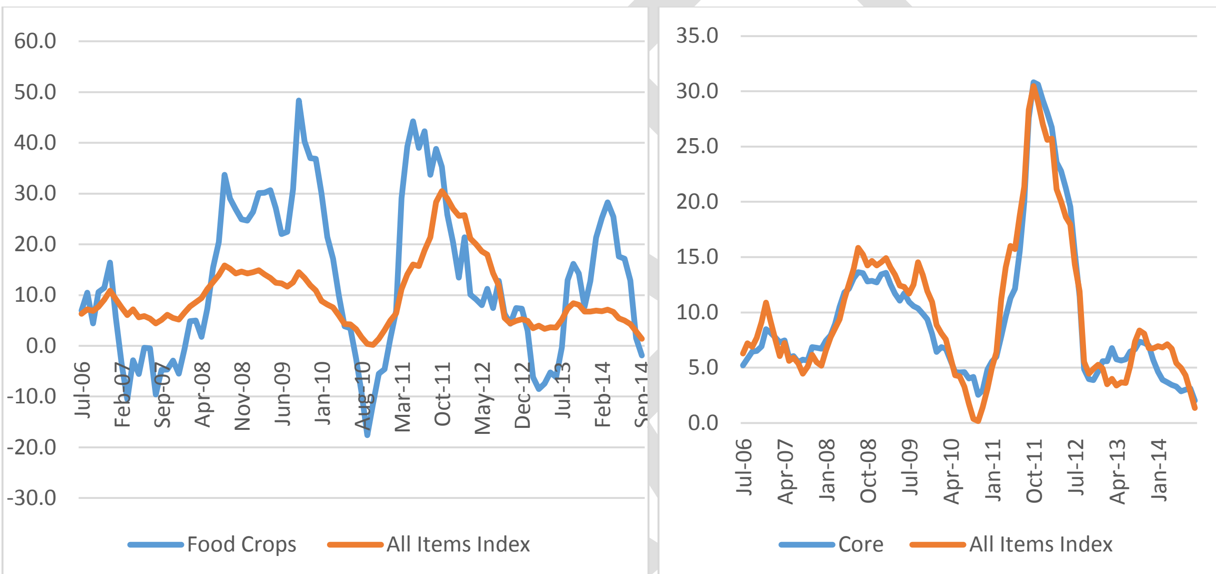
Source: Bank of Uganda

Figure 1 above shows that since the base year (2005/06), the general price of goods and services has increased by 54.8%. More to note is that since Uganda's economy is largely informal, the most weighted cause is food crops. In comparison, core inflation is 53.4%, EFU is 51.3% and Food crops is 62.1% since September 2005 (monthly). This still shows that food crops are the leading driver for inflation in Uganda.

Figure 2 below shows the trend analysis of the impact of the food crop inflation on headline inflation and also the same for core inflation. The results are clear that core inflation and headline inflation take the same direction over time and not clear which of them influences the other. On the contrary, food crop inflation clearly influences headline inflation (all item) as the spikes and troughs in the trends show that food crop inflation.

All this goes to show that the direction of both core and headline inflation in the next three months will depend on the direction of food crop inflation. The recent change in whether patterns to have more rains than anticipated has greatly served to keep the supply of food crops in the market steady thus a steady decline in the food crop inflation from March 2014 when it was at 28.3% to September 2014 when it was -1.9%. The discussion on the impact of climate change on the Ugandan economy then can no longer be avoided. Green budgeting is going to become the next efficient way to allocate resources in light of the discussion above.

Figure 2: Comparison between food crops and core inflation and their influence on headline inflation.



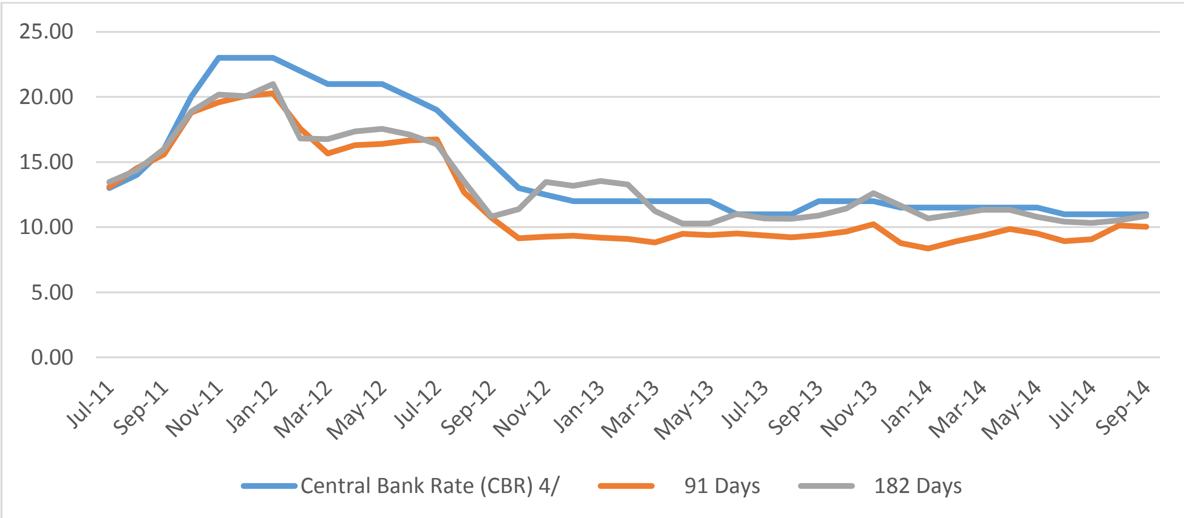
Source: Bank of Uganda

The Use of interest rates therefore to deal with inflation in Uganda only works to manipulate the small part of the economy that is banked and engages in the financial transactions through the banking system. According to the FINSCOPE survey 2013, overall usage of informal financial products and services increased by 14 percentage points from 60% in 2009 to 74% in 2013. If this trend continues to be in the medium term, we shall see less and less of the impact of CBR on the inflation in Uganda.

Like we have argued before, CBR has still failed to bring down the lending rates even when it has been at 11% for four straight months now since June 2014. Figure 3 below shows that the CBR successfully guides the 91 and 182 days treasury bills rates and therefore a successfully tools to that extent. As regards the commercial banks' lending rates, there is still a challenge there because the commercial banks now resort to dealing in the Treasury bills as opposed to lending money to the real economy where goods and services are produced. What has in theory been a threat to the private sector in terms of crowding out is quickly becoming a reality as

Government continues to increase its' levels of domestic borrowing. Even then, we are yet to realize the positive impact of the fiscal stimulus that we talk of in the economy.

Figure 3: Trends between CBR and Treasury Bills rates (91 days & 182 days)



Source: Bank of Uganda

In conclusion we call upon government to focus more on the resolving the supply side constraints so as to make a clear case for the sustainably dealing with inflation in Uganda with the least of negative impact in the real economy. Specifically:

- Government should invest in agriculture research in order to increase production and productivity from the sector,
- Increase regulation of the financial market so that access to credit as a challenge is resolved,
- Revamp the Agriculture Credit Facility to be able to serve the wide spectrum of farmers in Uganda but also better its administration so that the Participating Financial Institutions (PFIs) do not reap off prospecting borrowers.