CIVIL SOCIETY BUDGET ADVOCACY GROUP

CSBAG response to the Bank of Uganda Monetary Policy Statement

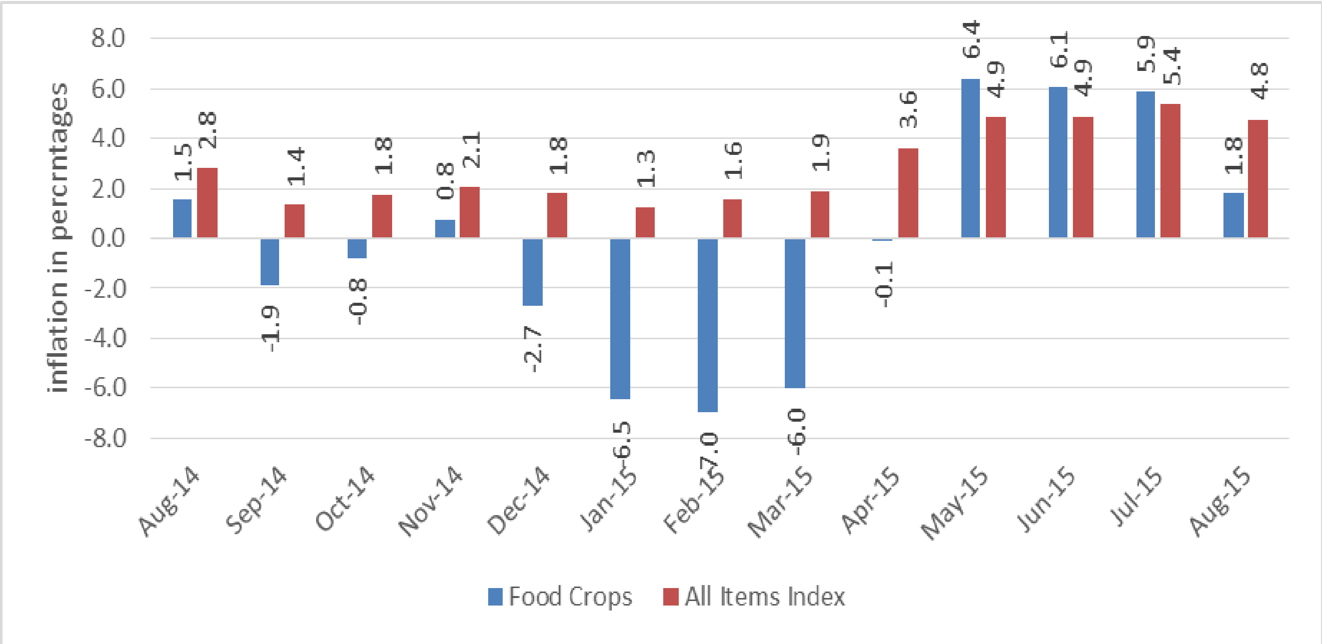
August 2015

IMPACT OF THE 16% CBR ON THE GROWTH PROJECTION OF UGANDA'S ECONOMY

INTRODUCTION

Inflation in Uganda is continuing to be a maze as to what drives it and as such what is the right instrument to control it, so as to avoid the replay of the surges that were witnessed in 2011. The food crops have for a long time had a critical influence on headline inflation and as such it contributes 27% of the total items contributing to inflation and this relationship is highlighted in figure 1 below.

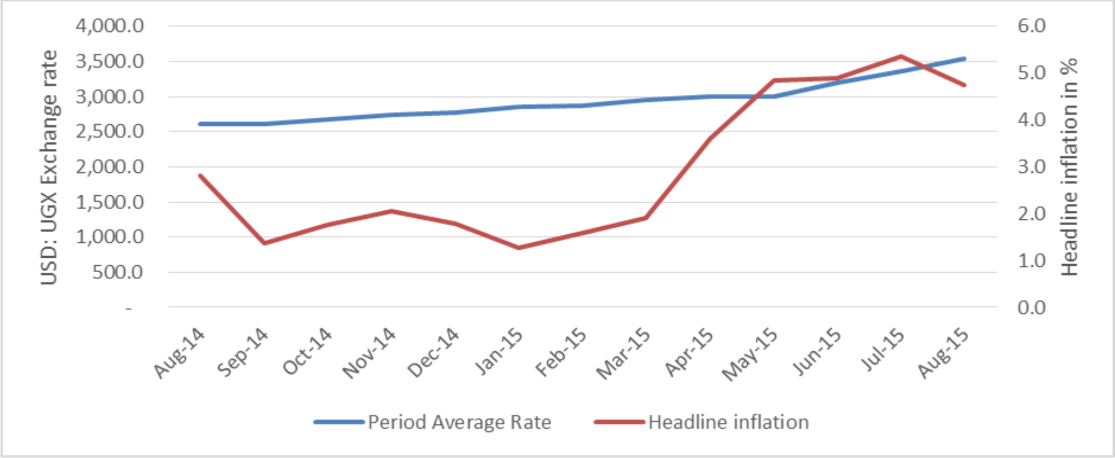
Figure 1: Positive relationship between food crop inflation and headline inflation



Source: BoU statistics and CSBAG computations

Headline inflation has experienced upward pressures since February 2015 and this was the same period when the food crop inflation was at an all-time low of -7%, but the transmission of the exchange rate depreciation into inflation was at getting more evident through increased prices of imports as indicated by the increase in the core inflation from 3.3% in February 2015 to 4.6% in April 2015. From April to July 2015 the food crop inflation had upward pressures and rose up to 5.9% in July form -0.1% in April 2015. As illustrated in figure 2 below, the exchange rate depreciation has had a positive impact on inflation on the whole.

Figure 2: Relationship between inflation and exchange rates in Uganda



Source: BoU statistics and CSBAG computations

Inflation in Uganda is currently driven majorly by food crop prices and exchange rate depreciation. The exchange rate depreciation more so for its transmission through the Electricity, Fuel and Utilities and the negative impact (price increase) in the real sector. The exchange rate question also has a play out in the external sector. The most recent statistics from the World Bank show that in 2014, Uganda spent UGX 19.988 trillion (USD 1.688 billion) on importing goods and services. This means that continued depreciation of the shilling vs the dollar as we are witnessing is ultimately going to increase the price of goods and services in Uganda. This translated into 29%[1] of Uganda's GDP in 2014.

Government expenditure which contributes just below 10% of GDP should not be priorities over HH consumption expenditure which contributes over 70% to Uganda's GDP. As such to better manage the Exchange rate and possible impact on inflation in Uganda, more structured interventions that will even call for change in ideology about the notion of free market. To this the following can be considered;

- *Regulate the financial sector with a view to encourage the commercial banks to extend credit to as many enterprises as can get. A specific time period ought to set with which the commercial banks should respond to policy directives in the market, supposedly one month*

- *Bank of Uganda should consider increasing the time lag within which the Monetary Policy Committee (MPC) sits so as to give time for the market to adjust to policy indications given by CBR, but also most economic fundamentals are significantly altered within two months so there predictive capacity is over estimated in a short time. The MPC can meet once every quarter.*

- *Market regulation on how to use and use foreign currency ought to be developed and enforced in Uganda's financial sector. The free market concept seems to have failed to regulate the forex market and so have the subtle OMOs by Bank of Uganda. This will curb unnecessary strain on the USD: UGX relationship and so enough forex will be release for necessary imports especially for equipment that will be used to add value to our agriculture produce but also boost our manufacturing subsector.*

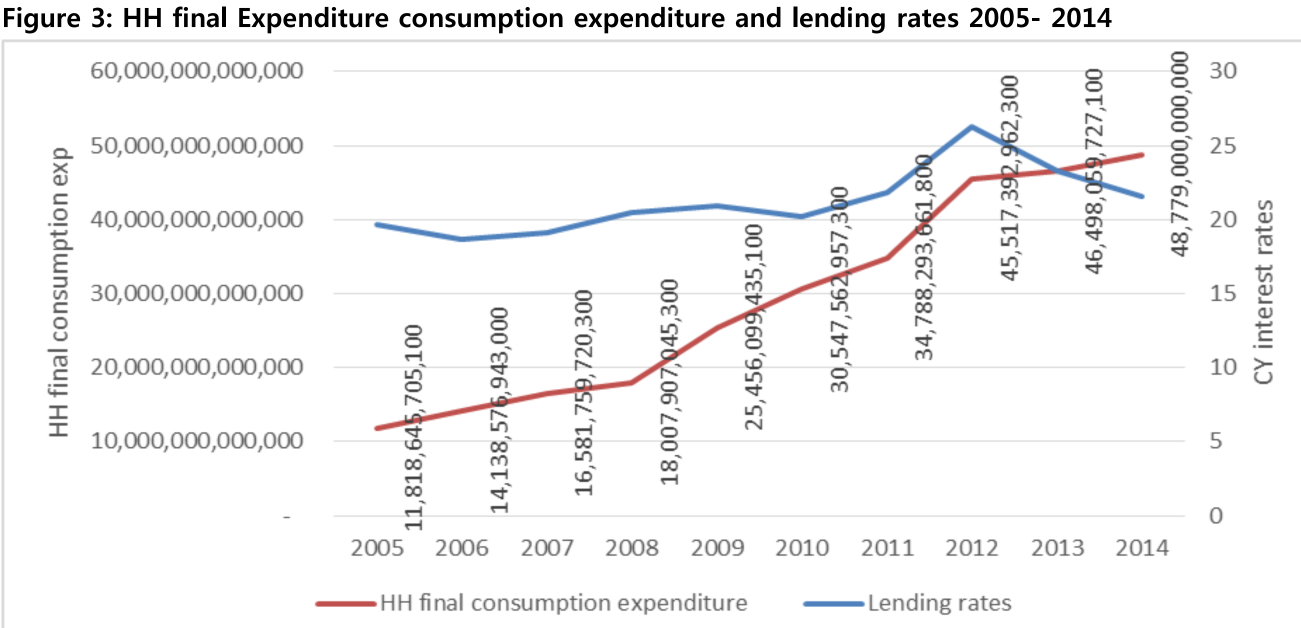
[1] The World Bank country statistics for Uganda.

THE PROBLEM!

The CBR as a policy instrument of the Monetary Policy (MP) in Uganda focuses on cash at bank through the control of the interest rates. It has been witnessed to only effectively, in the short run, when increasing commercial bank lending rates but ineffective when it indicates for commercial banks to reduce the lending rates. Other MP instruments that are used are the Treasury bills and Bonds, in addition to the Open Market Operations where actual cash (FOREX) is injected or withdrawn from the economy. The market failure in this is that the financial institutions are left to decide when they feel like they should reduce the lending rates.

The concern here is that assess to credit for investment and consumption are constrained and as such GDP growth forecast dampened. Failure to control exchange rates can constrain the government expenditure on the large infrastructure projects which are largely priced in FOREX at beginning of the respective FYs. Failure to regulate market tendencies like speculation that lending rates high, because the market would be perceived as risky, undermines the access to credit for HH consumption and investment. It should be noted that House Hold final consumption contributed 71.3% to GDP in the 2014 so any interventions that constrain it in effect are constraining GDP growth.

Figure 3: HH final Expenditure consumption expenditure and lending rates 2005- 2014



Source: World Bank statistics and CSBAG computations

General government final consumption expenditure as another strong contributor to GDP in Uganda (9.13%), can explain the increase in CBR to 16%. This can be collaborated by the increase in the 91 and 182days treasury bills interest rates from 13.39%[2] to 14.72% and from 14.48% to 15.72% in July and August 2015 respectively. In this way, the commercial banks will be enticed to buy the 1.384 trillion[3] that would factor into the domestic financing revenue mobilisation mechanism of GoU for the FY 2015/16 through treasury bills and bonds.

IMPLICATION OF THE INCREASE OF CBR TO 16%!

The UGX 23.9 trillion budget was an ambitious effort by GoU to implement a number of programmes and projects. With annual headline inflation since the beginning of the FY 2015/16 averaging at 5.1%, it is hard to perceive that the exchange rate depreciation substantive enough to project the inflation outlook to be so negative that Monetary Policy had to get more tight. Food prices which have a substantive bearing on inflation in Uganda do not project hostile forecast and the world fuel prices which had previously exerted upwards pressure on inflation in Uganda are still relatively low.

The pressure is on to have the revenue mobilized for the implementation of the FY 2015/16 budget as the so there is a concerted effort to use the Monetary Policy to manipulate the financial markets so that they provide the anticipated UGX 1.3 trillion in domestic financing. The increase of the CBR to 16% is signaling CBs to increase lending rates and thus mopping out liquidity from the market and ultimately crowding out the private sector in the financial market.

CONCLUSION

The inflation outlook in the medium term is subtle and from analysis of the key macro indicators, it will remain within a (+/-) 1 band of the 5% policy target. Continued efforts to curb inflation should be geared towards doing so but with minimal impact on the real economy. More regulation in the financial subsector, but also more discipline in the executing the Fiscal Policy will give Uganda more sustainable positive growth outlooks and ultimately attract FDI while also encouraging home grown inclusive investments.

[2] Bank of Uganda Statistics
[3] Budget speech FY 2015/16

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