Bank of Uganda's Monetary Policy: What it can do and what it cannot.

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There have been discussions in the media that Bank of Uganda's monetary policy has been a failure because both inflation and the exchange rate have continued to surge upwards despite the tight monetary policy stance. This article explains what monetary policy can do and what it cannot do in the current macroeconomic environment, with heightened uncertainty resulting from both domestic and external shocks.

What has caused the hike in prices?

Inflation has risen swiftly since January 2011. Consumer price index inflation accelerated from 5 per cent in January 2011 to 28.3 per cent in September 2011. This has exerted significant pressure on household disposable income and discretion to spend. A series of adverse supply shocks to the economy are the causes of this inflation but not excess demand. In particular, the rise in annual inflation has two main causes.

Food Prices

First, food prices have been driven up by supply side shocks to agriculture, both domestic and external. Food price inflation stood at 50.4 per cent in September 2011. Monthly food prices rose much more than expected by 8.4 per cent in September. Non-food inflation, which accounts for 72.8 per cent of the consumer basket, rose to 18.1 per cent in September 2011. The current high food prices are not unique to Uganda or the region but are a global phenomenon.

It is also important to note that episodes of food price shocks previously witnessed both in Uganda and globally are usually temporary in nature. This coupled with global commodity prices projected to decline could put downward pressure on inflation thus causing inflation to fall hard and fast next year, although when this will exactly occur is difficult to forecast at this time given the current elevated uncertainties, especially in the global economy.

Some have argued that price controls, or exportation limits should be instituted to contain inflation. This could cause more harm than good. This policy would restrain inflation temporarily and become a disincentive to food producers. In addition, policing this policy measure is almost impossible given the nature of Uganda's borders. Since foodstuffs constitute the bulk of Uganda's exports to the region, contributing almost 50 per cent of the total export receipts, a ban on food exports would aggravate Balance Of Payments (BOP) problems and therefore cause higher exchange rate depreciation, which would further worsen the inflation situation.

Exchange rate depreciation.

The second major reason for the sharp rise in inflation is the impact of exchange rate depreciation on imported goods prices, including fuel. The exchange rate has depreciated by 71 per cent between September 2008 and September 2011. It depreciated by 25 per cent against the US dollar in the last 12 months. Indeed, the prices of traded goods, which are mostly imported, have risen much faster than the prices of non-traded goods, which are produced in Uganda (annual inflation was 33 per cent for traded goods and 8 per cent for non-traded goods).

There are two main reasons for the exchange rate depreciation. First, Uganda's balance of payments has deteriorated markedly, largely because of problems in the global economy. Exports as a percentage of GDP declined from 15.3 per cent in 2009/10 to 14 per cent in 2010/11. Aid inflows as a percentage of GDP declined from 4.3 per cent to 3.5 per cent in the same period. In addition, Workers' Remittances and Foreign Direct Investment have been subdued largely because the major source of these is Europe and North America which have been experiencing severe economic contraction since 2007. In contrast imports have been buoyant both in volumes and prices, reflecting strong demand from both public and private sectors. Imports as a share of GDP increased from 26.6 per cent to 28.1 per cent in the same period. Consequently, the current account balance as a share of GDP worsened from minus 9.7 per cent in 2009/10 to minus 10.8 per cent in 2010/11, while the overall balance of payments as a share of GDP declined from a surplus of 1.4 per cent to a deficit of 3.5 per cent in the same period. This BOP imbalance implies that the economy has to adjust to the deterioration in the BOP through the depreciation of the exchange rate.

The second reason for the depreciation of the shilling has been sentiment-driven, on account of the growing turbulence in global financial markets. Investors all over the world have fled from what they perceive as risky assets, because of fears about the prospects for the global economy and the solvency of some sovereign borrowers. This has led to a weakening of the exchange rates of many developing countries and emerging markets in the last few weeks; including South Africa, Turkey, Kenya and Brazil.

BoU cannot finance the BOP deficit by selling foreign reserves as some people have suggested. Uganda's gross foreign exchange reserves currently total to US dollars 2.4 billion and these could have been depleted within 4 months if BoU had attempted to support the shilling. Imposing foreign exchange rate controls or fixing the exchange rate cannot be effective, because they would not tackle the underlying cause of exchange rate pressure which is the imbalance between supply and demand for foreign exchange. Imposing controls will also negatively affect private sector confidence in economic management. The depreciation of the exchange rate will eventually make imports more expensive and exports more competitive. In the short term most of the adjustment however has to take place through more expensive imports, because most exports are supply inelastic.

BoU occasionally intervenes in the exchange rate market to dampen erratic and disruptive fluctuations in the exchange rate. BoU's intervention in the foreign exchange rate market is on both buy and sale sides of the market and this usually results in a minimal impact on the foreign exchange reserves. For instance, in the financial year 2010/11, the net BoU intervention in the foreign exchange market amounted to a net sale of only US $0.66 million. In order to stem the depreciation pressures in the medium term, exports must expand and/or imports should reduce. In a flexible exchange rate regime, a depreciation of the exchange rate is one of the key mechanisms through which these adjustments take place as it makes imports costly, thereby encouraging domestic consumers to shift consumption spending to non-traded goods while at the same time making exports more profitable.

How does bank of Uganda conduct monetary policy and has monetary policy been a failure?

The upsurge of inflation has highlighted the complex challenges facing the country in an increasingly globalized world. Since the inflation pressures emanate from supply-side shocks rather than from excess demand pressures, the appropriate response under such circumstances has been to limit second-round effects. Given that monetary policy is effective only on the demand side, BoU's monetary policy strategy for reducing inflation involves putting downward pressure on demand for goods and services through a tight monetary policy. The contractionary monetary policy BoU has been implementing since July 2011 works upon total demand by altering the liquidity position of financial institutions and of firms and people desiring to spend on goods and services. This ultimately affects the interest rates in the economy.

Since July 2011, BoU's policy instrument has been the target it sets for the seven-day interbank interest rate-the Central Bank Rate (CBR). By changing the CBR, the Bank influences the entire spectrum of market interest rates. The CBR influences market rates in two ways: First, it directly influences the marginal cost of funding of banks and, secondly, it reflects BoU's stance on monetary policy. To evaluate whether BoU's monetary policy stance has been effective one has to analyse whether BoU's monetary policy actions have had any impact on the interest rates and liquidity conditions in the interbank money market. Interbank rates for 7-day borrowing which averaged between 4 and 5 per cent between 2009/10 and 2010/11, averaged over 20 per cent in between July 2011 and September 2011, while excess liquidity in the banking system which averaged around Shs. 130 billion between July 2009 and June 2011, declined to negative figures between July 2011 and September 2011. Indeed this liquidity tightness has caused BoU to intervene in the interbank money market by using reverse REPOS to avoid excessive liquidity stress that would otherwise bring the

entire financial system to a halt. This tight liquidity conditions due to a tight monetary policy stance has fed through to commercial banks prime lending rates and other rates. Higher interest rates mean that the yield on Ugandan assets in relation to foreign ones rises, which could lead to the exchange rate strengthening. This contributes to a fall in total demand. All in all, a higher interest rate means that both growth and resource utilisation will be lower. Lower demand also leads to companies slowing down their rate of price increase, with the result that inflation falls.

Contemporary debates in the print media, which have expressed the opinion that BoU's monetary policy stance is ineffective and that since it started monetary policy-tightening inflation has continued to rise are inaccurate. BoU's action to raise its CBR sets in motion a sequence of cause and effects that should eventually help to lower inflation. This monetary policy transmission mechanism, which runs from BoU's actions to changes in aggregate demand, the output gap and, eventually, inflation, is characterised by considerable uncertainty regarding the timing and quantitative importance of specific linkages. This is in part because major economic statistics, which serve as a basis for providing some indication of how the economy has evolved up to the present, are often uncertain with a lot of noise and are published with lags of a month or two and often subject to revisions. Consequently, most formal statistical data, both domestic and international, that are available for monetary policy deliberations are "stale."

Therefore, between BoU's policy action and the other effects, especially the final effect on the rate of inflation there are "long and variable lags" indicating not only that BoU must be patient while waiting for the results of its policy actions, but also that it must be prepared to accept a few surprises while it is still waiting. Analysis indicate that BoU's policy actions have almost immediate effects on the interest rates, but it takes between 6 and 12 months for most of the effect on aggregate output to be observed. And even these estimates are subject to considerable variation. In particular, these long time lags mean that BoU must be forward-looking in its policy decisions; but the future is only clearly visible once you are there. Because of imperfect information that is often revised, even several months after the fact, BoU genuinely has a difficult time knowing with precision what is happening in the current month until it is two or more months down the road. Whatever the time lag, when BoU raises the CBR, eventually commercial banks must decrease their quantity of credit supplied. With a reduction in the amount of credit in the economy, there will eventually be a reduction in the volume of transactions for goods and services, and thus a decline in the overall demand for money with which to make these transactions.

In conclusion, looking at the developments as summarised in the preceding discussion, the right thing for BoU at present is to bring down inflation. BoU will not allow inflation to keep on rising, because it will keep raising interest rates until inflation is clearly on a downward trajectory. Indeed, the outlook indicates that consumer prices will ease after peaking this year, as food prices gradually moderate. The speed at which inflation falls will depend on how quickly the supply side shocks to food prices dissipate and the extent to which further adjustment in the exchange rate is necessary to equilibrate the balance of payments. However, risks for economic slowdown are decidedly tilted to the downside because of the heightened global economic uncertainty. In addition, inflation is still high in a number of Asian countries, from which Uganda's imports originate. Therefore, BoU will endeavour to delicately balance the need to guard against extreme risks to growth but also limit the adverse impact of prolonged inflation. Indeed, in part due to this balancing, real GDP recovered from 5.5 per cent in 2009/10 to 7 per cent in 2010/11.