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Monetary Policy Statement for July 2012

Both annual headline and core inflation continued their downward trend in June 2012, further consolidating the disinflationary progress that has been achieved since the final quarter of 2011. Annual headline and core inflation fell to 18.0 percent and 19.5 percent respectively in June. Since the start of 2012, the monthly headline and core inflation rates have averaged only 0.6 percent and 0.3 percent respectively; inflation rates which when annualised are clearly well below 10 percent.

The BOU's forecasts for inflation take account of both domestic and external factors. On the external front, the weakness of global GDP growth together with lower commodity prices, including fuel prices, has alleviated some of the upside risks to inflation in Uganda. On the domestic front, food crop prices have fallen in the last two months with the onset of the rainy season and will probably decline further in the short term. Although real GDP in quarter 3 of 2011/12 picked up after the poor performance in the previous quarter, real output was still below potential output. The aggregate demand that is below the potential output will also dampen inflationary pressures. Growth in Shilling denominated bank loans has remained very weak since September 2011, partly because of the increase in bank lending rates. In contrast, growth in foreign exchange denominated loans has been robust.

In line with the factors discussed above, the Bank of Uganda is confident that core inflation will fall to single digits by the end of this year and that it will fall further in 2013 to the medium term target of 5 percent. In the next three months, we are likely to witness a more rapid fall in annual inflation rates, because of the base effects arising from the sharp increase in inflation in the corresponding period last year. The main threat to further disinflation emanates from a possible weakening of the exchange rate, given Uganda's persistently large trade deficit and the volatile nature of capital flows to frontier markets such as Uganda. As we emphasised in last month's monetary policy statement, the BOU will not defend any particular value of the exchange rate, but it will intervene to stabilise the exchange rate in the event of disruptive volatility.

The strategic objectives of the BOU's monetary policy in the short to medium term are to maintain the downward path of core inflation towards its medium term target of 5 percent while at the same time encouraging a recovery in private sector credit from the banking system to support stronger growth in the real economy. The expected fall in inflation over the course of the next 6-12 months will allow a gradual reduction in policy interest rates which the BOU expects to be passed onto borrowers in the form of lower lending rates. Accordingly, the BOU will reduce the Central Bank Rate (CBR) by one percentage point to 19 percent for the month of July. The band around the CBR will remain at plus or minus 3 percentage points. The margin on the Rediscount Rate and the Bank Rate will remain at 4 and 5 percentage points respectively above the CBR. Hence for July 2012 the Rediscount Rate will be 23 percent and the Bank Rate 24 percent.

Louis Kasekende

Dr. Louis Kasekende
DEPUTY GOVERNOR
July 03, 2012