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Monetary Policy Statement for October 2011

Inflationary pressures intensified in September. Annual headline and core inflation rates increased to 28.3 percent and 27.5 percent respectively, from 21.4 percent and 20.1 percent, in August 2011.

There are two main factors driving inflation; a food supply shock and exchange rate depreciation. Food prices have been driven up by supply side shocks to agriculture, both domestic and external. Monthly food prices rose much more than expected (by 8.4 percent) in September 2011. Nevertheless, food prices are still expected to decline over the coming months when supplies of food to markets increase. The second major reason for the sharp rise in inflation is the impact of exchange rate depreciation on imported goods prices, including fuel. The shilling/US dollar exchange rate has depreciated by about 25 percent over the last 12 months.

The priority for the Bank of Uganda is to gradually bring down the current high rates of inflation and stabilise it around the target of 5 percent in the medium term. The Bank of Uganda's strategy for reducing inflation involves putting downward pressure on demand for goods and services through a tight monetary policy. Dampening aggregate demand is crucial to prevent the higher prices emanating from supply side shocks and exchange rate depreciation from feeding through into prices throughout the economy. A tighter monetary policy involves raising interest rates, to curb the growth in bank credit and to encourage households to increase their savings. Raising interest rates is also intended to provide an inducement for net capital inflows to support the exchange rate.

Because the upside risks to inflation have increased, it is necessary to tighten monetary policy further. Accordingly, the Bank of Uganda is raising the Central Bank Rate (CBR) to 20 percent in October from 16 percent in September. The band on the CBR will remain at plus/minus 4 percentage points. Consequently, the lower and upper bounds of the CBR will be set at 16 percent and 24 percent, respectively, in October. The margin on the rediscount rate will remain at 5 percentage points above the CBR. The rediscount rate and the Bank Rate (the rate at which commercial banks can borrow from the Bank of Uganda against eligible collateral) have thus been increased to 25 percent and 26 percent, respectively.

Although the outlook for inflation deteriorated in September, the Bank of Uganda remains confident that annual inflation will peak towards the end of this calendar year and will fall back during 2012. 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 maintain external balance. However, should the upside risks to inflation increase in the months ahead, then monetary policy will be tightened further. The increase of four percentage points in the CBR which I have announced today should be seen as a clear signal of the Bank of Uganda's determination to bring inflation under control.

Emmanuel Tumusiime-Mutebile
GOVERNOR
October 04, 2011