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Monetary Policy Statement for October 2012

The disinflationary momentum strengthened in September 2012. Annual headline and core inflation fell sharply to 5.4 percent and 4.8 percent respectively in September from 11.9 percent and 11.4 percent in August. The monthly headline and core inflation rates averaged 0.1 percent and 0.2 percent over the last three months. The monthly core inflation rates nonetheless have probably reached a short-term trough and are unlikely to fall further. The abatement of inflationary pressures in the economy over the last nine months reflects weak domestic demand pressures, with the economy still operating below potential output levels, and the relative stability of the nominal exchange rate.

Inflationary pressures are likely to remain subdued in the short-term. The BOU expects annual core inflation to stabilize at around 5 percent in the last quarter of 2012 and to remain at approximately that level in the first half of 2013. Nevertheless, all forecasts are subject to risks. The main upside risks to the inflation forecasts are domestic supply shocks, particularly to food production, higher global commodity prices and exchange rate depreciation as a result of the weak external current account.

In the short-term, monetary policy will continue to emphasize stimulating a recovery in aggregate demand in order to boost real economic growth, while safeguarding against any resurgence in inflation. Consequently, the BOU will reduce the Central Bank Rate (CBR) by two percentage points to 13.0 percent for October 2012. This will bring the cumulative fall in the CBR, since February this year to 10 percentage points. However, the reduction in the CBR has not been passed through fully to Commercial Banks' lending rates. I note that some of the commercial banks have reduced their prime lending rates and I hope that, in October, we will see a significant reduction in bank lending rates for all borrowers.

The sharp drop in the annual inflation rates, of 6-7 percentage points that occurred in September will not be repeated in the near term, because it was mainly caused by the so called "base effects". The BOU now believes that, with the reduction in the CBR to 13 percent, the CBR is now approaching a level which is consistent with a stable core inflation rate of 5 percent. Consequently, any further reductions in the CBR in 2012 are likely to be small, unless there is a major downward shock to inflation and aggregate demand more broadly, which seems unlikely in the short-term.

The band on the CBR will remain at +/-3 percentage points and the margin on the Rediscount Rate will remain at 4 percentage points on the CBR in October 2012. The Rediscount Rate and the Bank Rate will now be set at 17 percent and 18 percent respectively.

Prof. Emmanuel Tumusiime-Mutebile

<u>Governor</u>

October 02, 2012