Assessing The Effectiveness Of The Central Bank Rate In Controlling Uganda's Current Inflation

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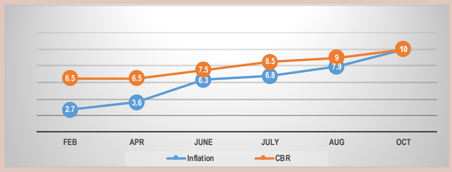
The Bank of Uganda Monetary Policy Committee (MPC) met on October 6 2022 as has been the custom every two months and revised the Central Bank Rate to 10 percent to control Uganda's soaring inflation which currently stands at 10 percent[1]. According to various MPC reports by the Bank of Uganda, the elevated risk of inflation is a result of intensified global factors by the ongoing Russia-Ukraine conflict, global supply chain disruptions, the recent temporary drought & depreciation of the Ugandan Shilling against stronger currencies. The October 2022 MPC report projects a further upward shift in inflation from the current 10 percent resulting from aggressive monetary policies by major central banks that might further weaken the Uganda shilling, further increase crude oil prices, and sustain supply shortages as Russia-Ukraine conflict intensifies[2]. Given these developments, what does this mean for the continuous revision of the CBR?

Impact of High CBR on the Economy

As illustrated in figure 1, the persistent increase in the CBR has not stopped the skyrocketing inflation. Putatively, the adjustment of the Central Bank rates is an effective contractionary monetary policy tool for managing inflation. However, this is based on the assumption that inflation is demand-driven (too much money chasing too few goods) which is not the case for Uganda. The MPC suggests contractionary monetary policy measures yet the current inflationary pressures are supply-driven which may arise from Uganda's high dependency on imports. Consequently, the increase in the CBR may only restrain internal production without solving the pricing problem.

Figure 1: Inflation and CBR Trends



Author's computations Based on the MPC reports from February to October 2022

Regarding demand-driven inflation, revising the CBR upwards increases interest rates thus increasing the cost of credit. It not only crowds out the private sector but also, discourages firms from borrowing thus affecting their productivity and efficiency. The reduction in consumer spending reduces aggregate demand triggering a decline in prices and consequently controlling inflation.

The continued increase of the CBR by the Central bank of Uganda is going to see the cost of credit go high and commercial banks and other credit institutions will charge high interest because they are borrowing from BoU

1 BOU. (2022, October 6). Bank of Uganda. Retrieved from Bank of Uganda:https://www.bou.or.ug/bou/bouwebsite/RelatedPages/Publications/article-v2/Monetary-Policy-Statement-October-2022/#:~:text=At%20the%20Monetary%20Policy%20Committee,percentage%20point%20to%2010%20percent.

2 ibid.

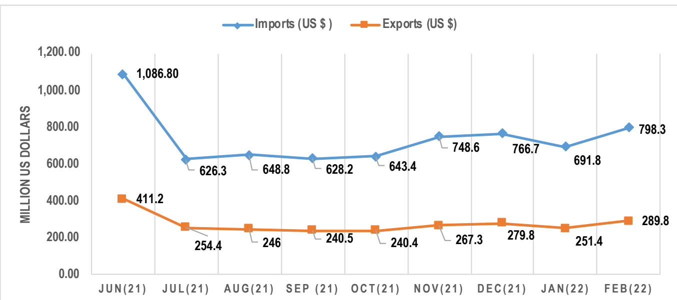
expensively. The banks will then transfer this burden to you and me the customers. High-interest rates will encourage the public to save thereby reducing aggregate demand.

The reduced money in the economy to control inflation will suppress demand for goods and services leading to a recession- a period of negative growth in the economy. This has already been forecasted by the BoU during the reading of the September state of the economy report, 'Economic growth is expected to remain below its long-run trend until the financial year 2025/2026'[3]. The statement continued to add that tight financial conditions will likely weigh on domestic economic growth.

Impact of Imports and Exports on Inflation

Is Uganda experiencing demand-driven inflation pressure currently? The honest answer from the MPC reports by the bank of Uganda is no. The high inflation in the country is a direct result of a rise in the cost of imports also commonly known as imported inflation. Uganda is a net importer which means that the value of imports is greater than that of exports signifying a trade imbalance and terms of trade deficit. In addition, the country runs a financial account deficit meaning that its capital outflows from investments, equity, and debt securities exceed inflows. Generally, the country has consistently reported a current account deficit for the last few financial years. The current account is measured as a proportion of the country's total output (GDP) which stood at -8.4 % in July 2022 according to the Bank of Uganda state of the economy report (September 2022)[4]. The same report projects that in the medium term, the current account deficit will continue to widen, before progressively narrowing in FY2026/27. Data from the Uganda Bureau of Statistics (UBOS)[5] shows that on average over the 9 months from June 2021 to February 2022, the trade deficit stood at USD 462 Million.

Figure 2: Uganda's Imports and Exports for June 2021 to February 2022



Source: Author's illustration based on UBOS trade data

Although the country's exports have been growing post-COVID-19, the value of the imports has been rising at a faster pace largely due to the elevated global commodity prices, particularly oil prices. In February 2022, total exports increased by 15.3 percent from US$ 251.4 million in January to US$ 289.8 million in February 2022. Total import flows increased by 15.4 percent from US$ 691.8 million to US$ 798.3 million over the same period. The continued running of the import value ahead of the export value poses a colossal problem to monetary policymakers as the situation has an impact on inflation, domestic currency performance, and the country's forex reserves.

Impact of Remittances

Remittances from the diaspora remain one of Uganda's main alternative sources of foreign exchange for cushioning the reserves hence supporting the local currency from depreciating. Although the flow of remittances to Uganda from the people living and working in the diaspora declined by 26% from USD 1.4b in 2019 to USD 1.1b in 2020, the country still ranked among the top ten remittance recipient countries in sub-Saharan Africa. This shows the importance of remittances in Uganda and the potential fragility of the country's main source of foreign exchange.

Implications for the Economy

- The inflation affecting Uganda is not connected to the money in circulation but rather driven by other factors, including high exchange rate depreciation. Therefore, an upward revision of the CBR has little or no effect on relieving inflationary pressure. Ugandans are likely to continue struggling with high food prices, fuel, and transport among others until the global supply chain bottlenecks are fixed.

- The continued revising of CBR upwards will most likely lead to an increase in domestic debt interest rates. In addition, it remains to be seen whether banks in Uganda will not move to increase their interest rates on credit. In this case, the extent to which commercial banks will adjust their interest rates is not yet clear but adjusting upwards is the logical move considering commercial banks are risk averse and the government is the largest borrower from the domestic market.

- The depreciation of the Uganda shillings against major currencies remains a big problem. We are likely not to see stabilization in the local currency until there is a reduction in the trade deficit and capital flow imbalance.

- Rising the CBR discourages borrowing due to the high costs. This eventually suppresses consumption. Suppressed consumption consequently reduces the overall demand for goods and services. This means that both businesses and producer companies are going to struggle, some will shut down, unemployment is going to increase, employees will take pay cuts and others will go months without being paid hence increasing poverty

3 Kidamba. M (2022 November). Uganda is headed for a recession. https://observer.ug/news/headlines/75809-uganda-headed-for-a-recession (Accessed on 15/11/2022)
4 BOU (2022 September). State of the Economy Report
5 UBOS (2022 April). Monthly Merchandise Trade Statistics Bulletin.

levels.

- In the case of Commercial Banks, we are likely to see an increased number of non-performing loans coupled with few people taking loans. Banks without a sizable amount of assets are likely to close due to losses unless inflation is brought under control soon.

Conclusion and Recommendations

Imported inflation and a weaker currency cannot be addressed through monetary policy and at most not through the increase in the CBR. Monetary and economic policymakers need to look at the cause of inflation and design appropriate measures and interventions. In the short run, little can be done to alleviate the current imported inflationary troubles, however, while it is important to manage inflation using a contractionary monetary policy (increasing the CBR), the government through MoFPED should exercise decisive fiscal decline, control the appetite for borrowing as it's watering down BoU efforts and fight corruption as supplementary measures.

- In addition, the government should facilitate more exports to take advantage of the shocks to reduce imported inflation because of the depreciation of the exchange rate.

- In the medium to long run, the country needs to shift focus from relying on the main agricultural exports of Coffee, tea, cotton, and fish as well as the diaspora remittances and focus on high value-added exports to encourage capital inflows to bridge the trade and capital flow imbalance.

- Otherwise, with supply-driven inflation, monetary policy responses should be complemented by several government response measures within the fiscal framework that focuses on reducing related supply challenges.