Emmanuel Tumusiime-Mutebile: The implication of the exchange rate depreciation for inflation and monetary policy

Remarks by Mr Emmanuel Tumusiime-Mutebile, Governor of the Bank of Uganda, at the 10th Private Sector Foundation Uganda International Trade Expo, Lugogo, 25 August 2015.

* * *

Good morning ladies and gentlemen.

I would like to begin by commending the Private Sector Foundation for organising this Trade Expo, which performs an important role in promoting trade and industry in Uganda. In this address I want to take the opportunity to explain the macroeconomic policies which the Bank of Uganda is currently implementing to address the shocks facing the economy and ensure that it remains stable.

As you all know, Uganda's exchange rate has faced repeated bouts of pressure since the first half of 2014. On a trade weighted basis, the exchange rate has depreciated by around 23 percent since August 2014. The main reason for this depreciation is that Uganda has suffered several external shocks which have affected exports, tourism and foreign direct investment, while at the same time demand for imports has remained quite strong. We suffered a wider current account deficit in the last financial year and this deficit was not fully covered by surpluses on the financial account of the Balance of Payments.

Uganda is far from unique in facing exchange rate pressures. Many emerging markets and developing economies around the world, including in Africa, have seen their currencies fall sharply in value over the last year, mainly because of lower commodity prices and a reversal of capital flows.

The depreciation of the exchange rate has implications for the macroeconomy and for the different sectors of the economy. I will discuss the macroeconomic implications first and then address the sectoral implications.

Before discussing the impact of the depreciation on the macroeconomy I want to emphasise two important features of our macroeconomic framework. The first is that the primary objective of the Bank of Uganda's monetary policy is the control of inflation. This is because inflation is such an important variable in the economy, directly affecting the welfare of all the population as well as the business environment for the private sector and because it is a variable which it is feasible for monetary policy to control, at least over a medium term horizon.

Our target for annual core inflation is 5 percent. It is not realistic to control core inflation to 5 percent in every single month – sometimes it will be lower and sometimes higher – but it is realistic to aim for an average core inflation of 5 percent over a medium term horizon of two to three years. Over the last three years, since August 2012, core inflation has averaged 4.7 percent.

The main tool of monetary policy is our policy interest rate which we call the Central Bank Rate (CBR). *Ceteris paribus*, if we believe, on the basis of our economic forecasts, that inflation will rise in the future, we will normally raise the CBR, and vice versa.

The second feature of our macroeconomic framework that I want to emphasise is that we have a flexible exchange rate. We don't attempt to control the level of the exchange rate because it is neither feasible in a small open economy subject to external shocks nor is it desirable, as I will explain later when I discuss the sectoral effects of the depreciation.

The BOU restricts its interventions in the foreign exchange market to dampening volatility in the exchange rate when this becomes excessive.

The exchange rate depreciation is a negative supply shock for the economy. It raises the cost of supplying goods and services in the Ugandan economy, because many of these goods and services are either directly imported or are produced locally but use imported inputs in their production. Such a shock will unavoidably raise inflation, although it usually takes up to a year for the full effect of an exchange rate depreciation to be felt on domestic prices. The questions which macroeconomic policy makers must address are: how much additional inflation should be tolerated? And what can be done to curb the rise in inflation?

Core inflation is still at very moderate levels; it was 5.4 percent in July. But given the magnitude of the exchange rate depreciation over the last 12 months, and the fact that this depreciation has not yet fed through fully into higher domestic prices, there would be a strong danger that inflation would rise to around 15 percent if the BOU had not tightened its monetary policy in recent months. That is why we have raised the CBR, in three steps, from 11 percent in April 2015 to 16 percent earlier this month. Core inflation will inevitably rise to some extent over the next 12 months, but by raising the policy interest rate we aim to restrain this rise and keep inflation within single digits. We believe that core inflation will begin to fall back towards five percent in the second half of 2016. We are determined to avoid any repeat of 2011 when core inflation rose to 30 percent.

The increase in the CBR is intended to influence other interest rates in the economy, including bank lending rates; otherwise it would not work to curb inflation. We have already seen commercial banks raise their prime lending rates.

The average prime lending rate of the commercial banks is currently just under 23 percent compared to 21 percent in January of this year.

Higher interest rates will reduce borrowing by the private sector and thus dampen demand for goods and services in the economy, which will help to alleviate inflationary pressures. In addition, raising the CBR has a signalling effect which we hope will influence the expectations of the private sector. If private sector agents expect that inflation will be kept under control, actual increases in wages and prices are more likely to be moderate.

The increase in the CBR and consequent reduction in the growth of demand will also have a temporary impact on the growth of real output. Hence we now expect that real growth in the current financial year will be lower than the 5.8 percent forecast at the time of the budget in June, and will probably be around 5.4 percent.

Unfortunately, if we want to control inflation in the face of an adverse supply price shock, some costs in terms of lower real growth cannot be avoided. However, we expect that real GDP growth will climb towards 6 percent over the medium term.

Let me now discuss the sectoral impacts of the exchange rate depreciation, which differ between the traded goods and the non-traded goods sectors of the economy. The traded goods sectors are those which produce for export or which produce goods that compete against imports in the domestic market. What matters for the competitiveness of the traded goods sectors is the real effective exchange rate, which is a measure of changes in the nominal exchange rate of the Ugandan Shilling against the currencies of our trading partners adjusted for differences in inflation rates. Over the course of 2014/15, the real effective exchange rate depreciated by about 13 percent, thereby boosting the competitiveness of the traded goods sectors of our economy.

This illustrates one of the most important benefits of a flexible exchange rate; it helps the economy to adjust to external shocks. Although the real effective exchange rate is not the only factor which affects the competitiveness of traded goods industries, the depreciation is still important, because it strengthens the price incentives facing traded goods industries.

We need to strengthen the performance of our traded goods industries. In the six years since the global economic crisis broke out in 2008/09, the growth of Uganda's goods exports has been weak, averaging only 3 percent per annum in dollar terms. Services exports have done much better, with average growth of 16 percent over the last 6 years, but this has not been sufficient to prevent the trade deficit in goods and services from widening from $2.2 billion in 2008/09 to almost $3 billion in the last financial year.

Over the medium term the growth of Uganda's demand for imports is likely to be robust especially because of the large requirements for capital investment. If we are to avoid our trade deficits widening further, it is imperative to strengthen the growth of exports and of industries which can compete with imports. I hope that the real exchange rate depreciation that has occurred over the last 12 months will contribute to an improved performance of the traded goods sectors.

A real depreciation of the exchange rate has the opposite impact on the non-traded goods sectors of the economy; these are sectors which sell their output on the domestic market and do not face competition from imports. The real depreciation will squeeze their profitability, *ceteris paribus*, just as it strengthens the profitability of the traded goods sectors. From the standpoint of the long term interests of the economy, shifting relative price incentives from the non-traded goods sectors to the traded goods sectors is necessary if we are to achieve lower trade deficits.

To conclude, I want to emphasise that our economy has to adjust to the external shocks that it is facing. Adjustment of some sort is unavoidable, but policymakers have some choice over the nature of the adjustment to the shock. Our policy responses to the shock prioritise controlling domestic inflation because inflation has such a critical impact on everyone in Uganda, including everyone in the business sector. We will ensure that inflation remains firmly under control.

Thank you for listening.