# Emmanuel Tumusiime-Mutebile: Macroeconomic management in turbulent times

Presentation by Mr Emmanuel Tumusiime-Mutebile, Governor of the Bank of Uganda, to the NRM (National Resistance Movement) Retreat, Kyankwanzi, 19 January 2012.

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## Introduction

I want to begin by reminding you of the difficulties which are currently facing economies all over the world. The IMF has warned that the global economy has entered a "dangerous new phase". Also, the World Bank, in its Global Economic Prospects Report released this week, warned that the "world economy has entered a very difficult phase characterised by significant downside risks and fragility". Given that the Ugandan economy is closely linked to the rest of the world through trade, tourism, workers' remittances, donor aid, foreign direct investment and other types of capital flows, it cannot be fully insulated from the serious problems affecting other parts of the global economy.

We should bear this in mind when debating the available policy options for our own economy. Since the global financial crisis in 2008 and the subsequent Great Recession in industrialised countries, the global economic environment has become much less propitious for developing countries such as Uganda. The global economy has become more volatile and generates macroeconomic shocks which are transmitted to developing economies. This means that we have to be more cautious in our approach to macroeconomic management and to build up buffers of resources – for example foreign exchange reserves – which can help us to ride out economic or financial shocks when they occur, as they inevitably will. Sound macroeconomic management, including prudent fiscal and monetary policies, will become even more important in this age of global turbulence than they have ever been in the recent past.

## The current economic situation

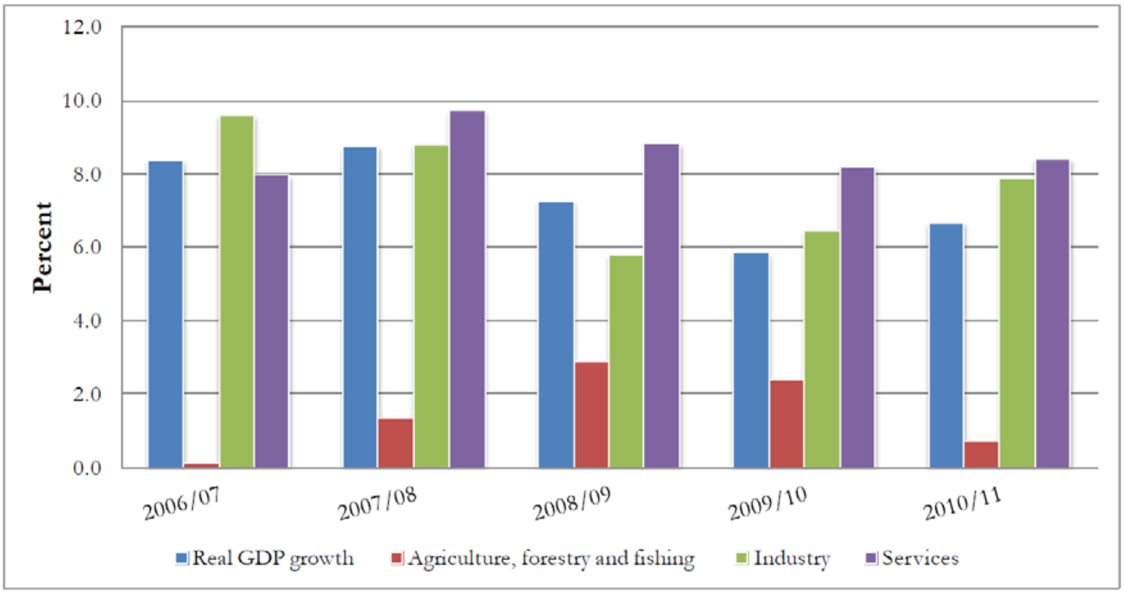
Three broad trends characterise the current economic situation, pertaining to real economic growth, the balance of payments and inflation.

## Real economic growth

Economic growth in Uganda has been relatively robust despite the problems in the global economy. Real GDP growth dipped just after the onset of the global financial crisis, to 5.9 percent in 2009/10, from the growth rates of 7–8 percent recorded prior to the global financial crisis, but then recovered to 6.7 percent in the last fiscal year. This is shown in figure 1. Growth in the industry and services sectors has been consistently strong over the last five years, in most years growth rates in these sectors have exceeded 6 percent per annum; but in contrast agricultural growth has been persistently weak and only occasionally exceeded 2 percent.

Figure 1

**Real GDP Growth (percent); 2006/07 to 2010/11**




Source: UBOS.

Despite the problems in the global economy and the need to tighten macroeconomic policies domestically to fight inflation, we are forecasting real GDP growth of about 5 percent in the current fiscal year and 6 percent next year. This is much better than the current global average economic growth of 2–3 percent. Talk of the economy being in crisis is, therefore, far removed from reality.

**The balance of payments and the exchange rate**

Uganda's balance of payments has deteriorated since the onset of the global financial crisis. Uganda has always run fairly large trade deficits but these have been funded with foreign savings from a variety of sources; workers' remittances, foreign aid and net capital inflows. However because of the slowdown in global growth and the economic recession in some of our most important export markets, include Europe, our exports have grown very slowly over the last three years, by only 4 percent per annum on average in US dollar terms. In contrast, our import bill has grown much faster, by about 10 percent per annum on average, because the buoyancy of the Ugandan economy has raised incomes and thus demand for imports. The consequence of this divergence in the growth rates of exports and imports is that the trade deficit has widened. In the last fiscal year the trade deficit in goods and services was 20 percent of GDP, compared to only 13 percent of GDP in 2007/08.

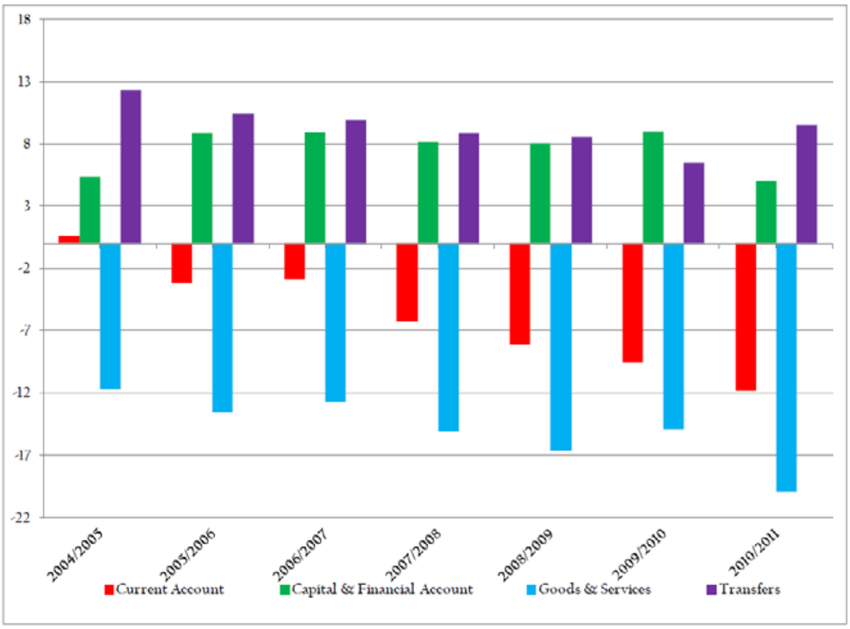
The widening trade deficit since the mid 2000s is shown in figure 2, along with the current account deficit, of which a major component is the trade deficit. The current account deficit has also widened since the mid 2000s. Also shown in figure 2 are the capital and financial account surpluses, which have not increased to match the widening current account deficits.

Unfortunately, the problems in the global economy mean that it has become much harder to mobilise foreign savings to fund our wide trade deficits. Foreign savings have increased slightly in US dollar terms, but as a share of our GDP foreign savings have been virtually flat over the last four years, at about 18 percent of GDP. Whereas foreign savings were more than sufficient to fund our trade deficits prior to the global financial crisis, allowing Uganda to run BOP surpluses and accumulate foreign exchange reserves, this is no longer the case. This is the main reason why our exchange rate has been under so much pressure, as shown in figure 3. Our trade deficits are becoming unsustainably large.

Figure 2

**Components of the Balance of Payments; current account balance, capital account balance, balance of trade in goods and services and transfers**

(percent of GDP)

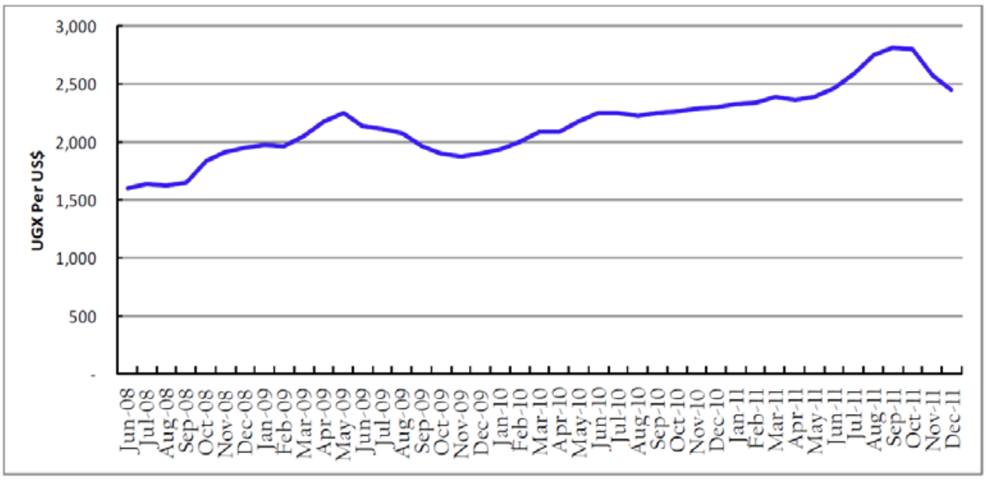



Source: BOU.

To rectify this problem will take time; we need to expand exports and shift our expenditures from imports to domestic goods where this is feasible. One of the main channels for bringing about this necessary adjustment to the trade balance is through the exchange rate. A weaker, more depreciated, exchange rate facilitates this adjustment because it makes the production of exports more profitable and makes imports more expensive. Structural policies, for example to support export production and reduce transport costs for exports, are also required, but structural policies alone will not work if the exchange rate is uncompetitive.

Figure 3

**The Exchange Rate of the Uganda Shilling against the US Dollar; June 2008–December 2011**



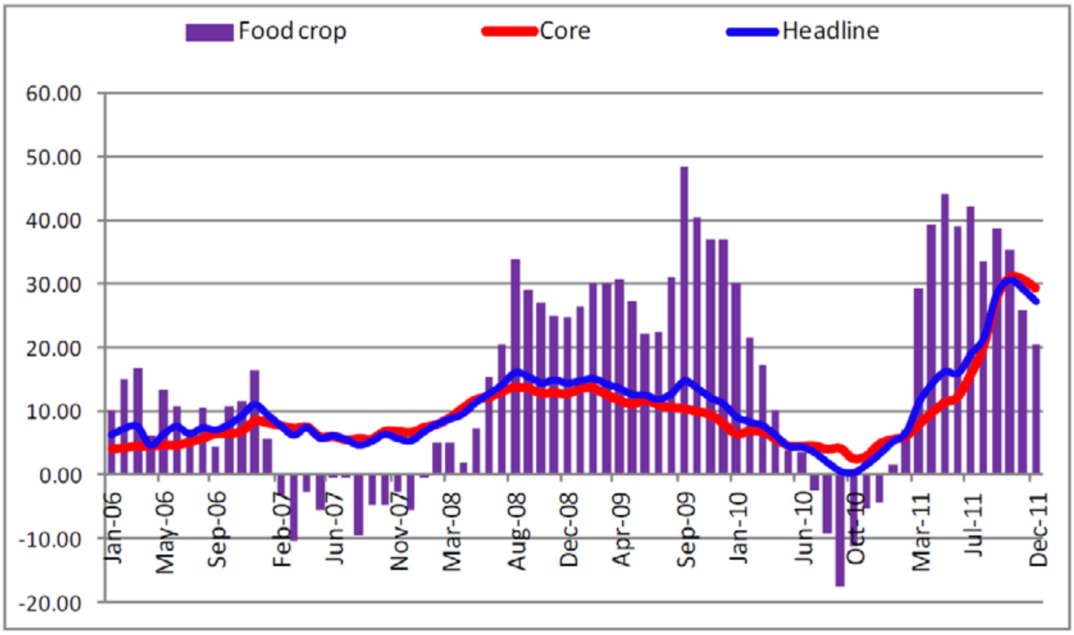

Source: BOU.

## Inflation

The third feature of the economy that I want to discuss is inflation and how we are tackling it. Annual inflation rose to 31.7 percent in October of last year, far above our target of 5 percent. The reasons for the rise in inflation and the policy response of the Bank of Uganda (BOU) have recently generated controversy, so I will take some time to explain what has happened in detail.

Figure 4

**Annual Inflation; Headline, Core and Food Crop (percent); January 2006–December 2011**




Source: UBOS.

Our record in controlling inflation over the long term has been very good. Over the last 20 years, since the early 1990s, annual inflation has averaged just over 6 percent. However, since the mid 2000s our economy has faced major exogenous, supply side, shocks which have affected domestic inflation. Inflation was forced up in 2008 by global food and commodity price shocks but was brought back under control in 2009 and 2010.

Inflation began rising sharply towards the end of 2010, as can be seen in figure 4. Initially this rise was driven by food price inflation. Food crop harvests were poor in Uganda and other parts of East Africa, while international world food prices were also pushed up steeply in the first half of 2011 by bad harvests in major cereal producers such as Russia. As a result, annual food crop price inflation soured to a peak of 42 percent in Uganda in May and remained high for several months thereafter. This was a pure supply side shock to prices and had nothing to do with excess demand or to too much money chasing too few goods.

The impact of food prices on inflation was exacerbated in the middle of 2011 by the weakening of the exchange rate. This was mainly due the deteriorating BOP position that I have just described, but the volatility in the exchange rate also reflected some speculation against the Shilling on the part of Ugandans who purchased dollars to hoard and foreign portfolio capital investors. The turbulence on the global financial markets, which entailed stock prices and exchange rates gyrating on a daily basis, also affected volatility in the Ugandan exchange rate and the exchange rates of other developing countries, including Kenya. Between the end of May 2011 and the end of September 2011, the nominal exchange rate of the Ugandan Shilling depreciated by 19 percent against the US dollar, as shown in figure 3.

The exchange rate depreciation drove up the domestic prices of imports; for example fuel, clothing and various household goods. Moreover, the combination of higher food prices and higher import prices began to spill over into other prices, such as the prices of services which comprise nearly half of the consumer basket. For example, school fees were raised because the cost of food had risen. By the first quarter of 2011/12, inflation was becoming more generalised in that it was affecting most items in the consumer basket. The very rapid growth in bank lending to the private sector, which by September 2011 had reached 44 percent on an annual basis, was also contributing to the build up in inflationary pressures.

**Monetary policy**

The rise in inflation created difficult challenges for monetary policy. Monetary policy affects the demand side of the economy; it influences spending by the private sector, which comprises about 80 percent of total final expenditure in the economy. Monetary policy does not affect the supply side of the economy; therefore it is ineffective as a tool for reversing pure supply side shocks to prices. Consequently monetary policy could not realistically be expected to have prevented the rise in food prices which occurred last year. However supply side shocks such as those which affected food prices and the exchange rate in 2011 will have serious long term consequences for inflation, long after the shocks themselves have dissipated, if they are allowed to spill over into a much broader range of prices, such that inflationary expectations become entrenched in the mind of the public. This is why it was imperative for the BOU to tighten monetary policy in 2011, by raising interest rates.

Interest rates are the main tool of a modern monetary policy in a market economy. The rationale for raising interest rates last year was threefold.

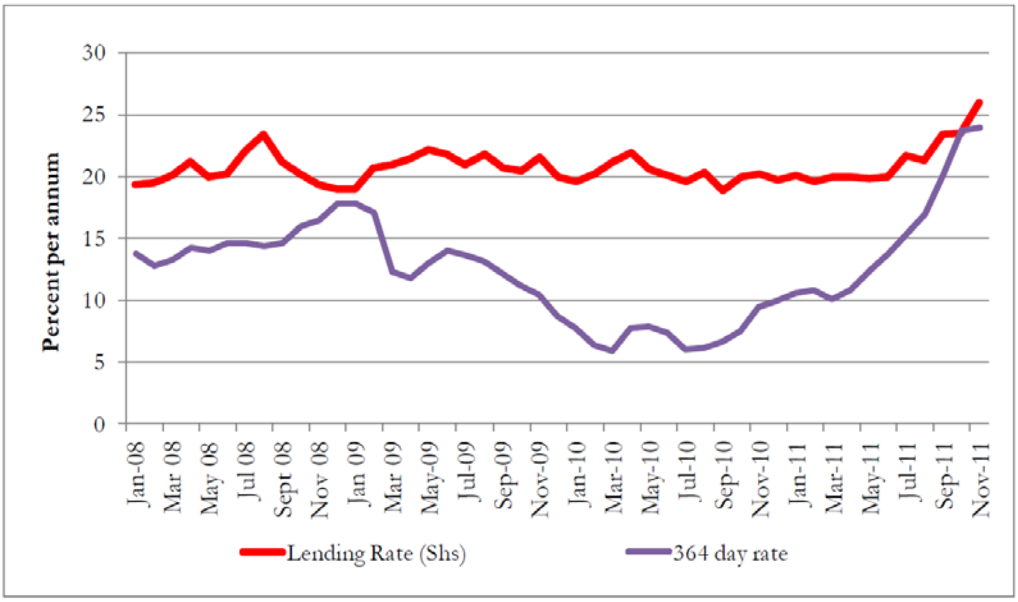
First, higher interest rates discourage borrowing by the private sector and, therefore, could be expected to bring about a slowdown in credit growth, which had been growing very rapidly in 2011 as I have already mentioned. Secondly, higher interest rates could encourage households to increase their savings and, therefore, reduce consumption. Both of these channels work by dampening the growth of private sector expenditures, thereby easing inflationary pressures as demand for goods and services weakens. It is a basic principle of economics that the price of goods and services is positively related to their demand. Thirdly, higher interest rates can provide support for the exchange rate, by attracting foreign portfolio investment. A stronger exchange rate takes some of the heat out of the inflation of the prices of imported goods and services.

The BOU's policy interest rate – the Central Bank Rate (CBR) – was raised from 13 percent in July 2011 when it was first introduced as the main policy tool of monetary policy, to 23 percent in November. It has been kept at 23 percent in the subsequent two months. The BOU does not fix commercial bank interest rates; that would be counterproductive in a market economy because it would distort business decisions and lead to borrowers being denied access to credit, because banks could not properly cover their costs of lending. The commercial banks must be free to set interest rates which reflect market forces and the specific characteristics of individual customers; for example the credit risk of borrowers. The CBR acts as a benchmark to guide commercial bank interest rates upwards or downwards. Hence when we raised the CBR we expected that commercial banks would raise their lending rates, as the marginal cost of funds was increased. This has happened. Most of the banks have raised their Prime Lending Rates and average bank lending rates have risen since the middle of 2011, as can be seen in figure 5. The interest rates paid on large term deposits have also been raised, reflecting the competition among banks for these deposits, although disappointingly most small depositors have not seen much benefit in terms of higher deposit rates.

In the last two to three months we have seen clear signs that our policies to fight inflation are starting to work. Bank credit growth has slowed markedly since September 2011, from an annual rate of 47 percent in September to 34 percent in November. The exchange rate against the US dollar has strengthened by about 15 percent since mid October, partly as a result of foreign portfolio capital inflows attracted by the higher interest rates in Uganda. Fuel prices have just started to edge down as a result of the strengthening of the exchange rate. In addition the food price shock has begun to abate. As a result of these positive developments, both headline and core inflation peaked in October and then fell back in November and December, as can be seen in figure 4. Monthly inflation rates, which provide a good indicator of current inflationary pressures, fell very sharply in November and December; monthly core inflation averaged only 0.6 percent in November and December, which was much lower than the average of 3.8 percent in the previous four months. Annual inflation rates are still high – headline and core inflation stood at 27 percent and 29.2 percent respectively in December – and we still have a long way to go to comprehensively subdue inflation, but we are moving firmly in the right direction. I am confident that if we persevere with our monetary policy stance we will be able to pull inflation down to single digits by the end of this year. As inflation falls during the course of this year, it will be possible to start reduce interest rates gradually.

Figure 5

**Bank lending rates and the 364 day Treasury Bill rate, percent: June 2008–November 2011**




Source: BOU.

## Concluding thoughts

I hope that I have helped you to understand the current difficulties facing our economy and the response of monetary policy, the primary objective of which is to control inflation. As I have explained, monetary policy is purely a tool of aggregate demand management. Economic policy consists of both demand management and supply side policies. The latter aim to strengthen the productive capacity of the economy; its aggregate supply. Fiscal policy is central to supply side policies although fiscal restraint is also important to support monetary policy in demand management.

Supply side policies comprise structural policies and mostly sectoral and microeconomic in nature; they include the construction of public infrastructure, incentives for private investment, competition and trade policies, and agricultural extension services. As a government we need to improve supply side policies to strengthen economic growth over the medium to long term, in particular by improving the quality of public services, the cost and quality of public infrastructure and the business environment. Supply side and demand management policies are not alternatives; they complement each other and both are necessary for sound economic management.