Emmanuel Tumusiime-Mutebile: Basic principles guiding monetary policy in Uganda

Speech by Mr Emmanuel Tumusiime-Mutebile, Governor of the Bank of Uganda, at the annual dinner of Uganda's Bankers' Association, Kampala, 30 November 2012.

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The Chairman and members of Uganda Bankers' Association,

Members of the Diplomatic Corps,

Distinguished invited guests,

Ladies and Gentlemen.

I am very pleased to be here with you at the traditional end of the year annual dinner of the Uganda Bankers' Association. I would like to thank the Chairman of the UBA for inviting me to be guest of honour at this occasion, which is an honour I appreciate greatly. I want to take this opportunity to make a few remarks about the basic principles which guide our monetary policy in Uganda, especially in the light of the reforms we have introduced over the last 18 months which, of course, are very pertinent for the banking industry.

As you all know, the BOU introduced a new monetary policy framework at the start of the last fiscal year. The new framework is an inflation targeting lite framework (ITL), similar in its basic features to that used by many central banks in advanced economies and emerging markets around the world. The primary objective of our monetary policy is to hold the annual rate of core inflation to 5 percent over the medium term. That does not mean that we will aim to keep core inflation at five percent all of the time, because that is neither possible nor desirable. Prices are subject to supply side shocks which can drive inflation up well above policy targets, as happened in 2011.

Monetary policy cannot realistically prevent inflation from rising in the short term if prices have been hit by a large supply shock, such as a food price shock, in Uganda or anywhere else in the world. What monetary policy can realistically achieve is to bring core inflation back down over a period of time, which in most cases will probably be in the region of a year at least, depending on the size and nature of the shock. When faced with a supply side shock to prices, of the type which hit our economy in 2011, the goal of the Central Bank must be to ensure that the initial rise in prices triggered by the shock does not feed into a self reinforcing spiral of higher prices, which would lead to higher inflation becoming persistent. The Central Bank cannot prevent a temporary rise in inflation, but it must not allow this to turn into permanently higher inflation. To avoid this, monetary policy has to be tightened to curb domestic demand, so that weaker demand gradually offsets the inflationary effects of the supply side shock. This is why we tightened monetary policy in 2011, by raising interest rates. As you may remember, the Central Bank Rate (CBR) was raised very sharply in the second half of 2011 because the supply side shock to prices was itself very large; for example, annual food price inflation rose to 50 percent in September 2011.

Once we saw evidence that inflationary pressures were abating and we were convinced that inflation was on a downward path, we were able to begin cautiously easing monetary policy, by reducing the CBR in February of this year. Inflation has now been brought back down to our medium term target of 5 percent. Looking ahead over the next 12 months, we intend to set our monetary policy, using the CBR, to maintain core inflation as close as possible to 5 percent.

Although inflation is the primary target of our monetary policy, we are also concerned with the growth of real output, which is a secondary objective of monetary policy. More specifically we aim to ensure that real output is in line with its potential level, which is determined by supply side growth. This means that, in circumstances where real output is below its potential level, we will use monetary policy to support a recovery of output provided that this does not undermine our ability to achieve our inflation target. In some circumstances, notably when the economy has suffered an aggregate supply shock, as was the case in 2011, there is an unavoidable conflict between achieving both the inflation and output targets. In these circumstances the inflation target has to take precedence, because otherwise the credibility of the Central Bank to control inflation will be jeopardized. However there are other circumstances where there is not an inherent conflict between the inflation and output targets. With the supply side shocks which hit our economy in 2011 having now abated, the conflict between the inflation and output targets has also largely dissipated, although it could re-emerge if the economy were hit by further supply side shocks in the near future.

We estimate that the potential growth of real output of our economy – which is determined by the growth of the labour force, capital investment and productivity growth – is currently in the region of 6–7 percent per annum. In the last fiscal year, real output growth was only 3.4 percent; about half of the potential growth rate. As a consequence, a negative output gap has opened up. Actual output is lower than potential mainly because of constraints on the demand side, which include constraints arising from macroeconomy policy and those emanating from the weaknesses in the global economy. Although we expect that real GDP growth will pick up in 2012/13, it will not be anywhere near fast enough to close the negative output gap and I do not think that real output in the economy will be restored to its potential level before 2013/14 at the earliest.

A negative output gap tends to dampen inflationary pressures, because it means that aggregate demand in the economy is weak relative to aggregate supply. Consequently, in the current circumstances it is possible to use monetary policy to try and boost domestic demand and, therefore, real output without jeopardizing our objective of controlling core inflation at 5 percent. This is why we have reduced the CBR over the last few months; we would like interest rates to fall to stimulate a recovery of bank lending and thus a recovery of demand for goods and services from the private sector.

However, it is necessary to recognize the constraints and limits on our ability to achieve our objectives for output. First, as I have already mentioned, the current coincidence of interests between our inflation and output objectives will only last as long as there are no further supply sides shocks to the economy. Secondly, in an economy which still has a relatively shallow financial system, the overall impact of monetary policy on aggregate spending in the economy is not large. The main transmission channel of monetary policy to the real economy is through bank lending to the private sector, but the stock of bank lending is only 16 percent of GDP. A large share of household spending in the economy is not directly affected by monetary policy, although there may be some indirect effects through employment. Furthermore, there are other factors, as well as monetary policy, which affect both the supply of, and demand for, bank credit, such as the level of household indebtedness and the value of assets such as land and property which are used as collateral for loans.

I would now like to turn from the objectives of monetary policy and make a few remarks about its operational modalities, and in particular the role of the Central Bank Rate in our monetary policy framework. In effect the CBR performs a dual role. It acts as a guide for short term interest rates and it provides a very visible signal of the stance of monetary policy. In modern monetary policy frameworks, the signaling of the stance of monetary policy plays a very important role in guiding expectations about the economy and the actions of the Central Bank. That is why we announce the CBR publicly at the start of every month and explain the thinking behind our interest rate decision.

Since the ITL framework was introduced, we have been able, using our regular interventions in the money market, gradually to bring short term interbank interest rates quite closely into line with the CBR. The average 7 day interbank rate for November was 12.6 percent, which is very close to this month's CBR of 12.5 percent. In turn other interest rates such as those paid on wholesale deposits are now also moving roughly in line with the CBR. As such the

CBR is now proving quite effective in influencing the marginal cost of funds for commercial banks. We have been less successful in influencing the path of bank lending rates; they followed the CBR up in the second half of 2011 but have been much slower in coming down this year, with the result that interest rate spreads have widened. I hope that, as our financial sector becomes more competitive and sophisticated, we will see bank lending rates become more responsive to changes in the marginal cost of funds for banks and interest rate spreads being reduced.

Finally I will briefly touch on the instruments of monetary policy. In the past, the main instrument of monetary policy was the regular primary auction of Government securities, which we used as a tool to control the monetary base. Under the ITL monetary policy framework, our operating target is the interbank interest rate, not the monetary base, and the tool we use to influence the interest rate is secondary market operations in the money market, mainly repos and reverse repos. The primary auctions of Government Securities are now used to fund the Government's domestic borrowing requirement and to refinance the existing stock of securities as they mature, rather than as an instrument of monetary policy. Furthermore, the Government will fund fully its domestic borrowing requirement from the market, by issuing securities, without recourse to any funding from the Central Bank. It is possible that we might occasionally use a primary auction of securities for monetary policy purposes in the future, but this will be the exception rather than the rule and if we do so we will announce this explicitly, to avoid any confusion.

I hope that you have found these remarks useful. As I noted earlier, transparency and communication play a vital role in modern monetary policy frameworks, so it is very important that the public and especially decision makers in the banking and business communities have a good understanding of what the Central Bank aims to achieve and how this will affect the economy.

Lastly, I would like to congratulate the Uganda Bankers' Association and its members for all of their efforts to over the course of this year and in particular for their work in developing and promoting a code of ethics and good banking practices to guide all members of the UBA.

Thank you for listening to me.