



CSBAG BUDGET NEWS BRIEF



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Advocating for a People Centered Budget that Dignifies Humanity



CBR should be lower than 15% given the economic fundamentals!

"In this Edition, CSBAG brings you its analysis of the Bank of Uganda Monetary Policy Statement released June 2016".



The reduction of the CBR to the current 15% will take a very long time before it transmits to the lending rates. Photo © Churchill

Under the Monetary Policy framework, Bank of Uganda sets a monthly Central Bank Rate (CBR) that is based on 3 areas including the inflation outlook, the projected output gap as well as other macroeconomic fundamentals. With this strategy BoU seeks to maintain price stability with a medium term core inflation target of 5 percent.

In FY 2015/16, BoU used the Repurchase (REPO)/Reverse Repurchase agreements as well as issuance of Government Securities. Government continued to support monetary policy operations by further recapitalizing BOU in FY2015/16 through securities worth UGX 200 billion. These recapitalization securities issued in the secondary market continue to supplement the REPO and reverse REPO instruments in liquidity management.

FY 2015/16 has seen BoU pursue a tight monetary policy stance in a bid to rein-in on inflationary pressures. The CBR was increased from 13 % in June 2015, to a high of 17 % by October 2015 which was maintained until March 2016. The band on the CBR was maintained at +/-3 percentage points (PPs) and the margin on the rediscount rate at 4 percentage points on the CBR over the same period.

The tight monetary policy stance was deemed appropriate because the risks to the medium-term inflation outlook were, on balance, sufficiently tilted to the upside, despite indications of weaker growth. At the time, the impact of exchange rate depreciation was slowly feeding through to domestic prices, and this continued to put upward pressure on domestic inflation.

In addition, global weather forecasts indicated a possible increase in the severity of the El Niño weather phenomenon, which could disrupt food production and distribution, with possible adverse consequences on food prices.

"In June 2016, Bank of Uganda reduced the CBR by one percentage point to 15 %."

By April 2016, the inflation outlook had improved as pressures on the exchange rate began to subside, food prices declined faster, and due to the persistent subdued global outlook that would expectedly weigh in on inflation, directly through lower import prices and indirectly via dampened domestic economic activity. As such, BoU reduced the CBR by one percentage point to 15 %. Consequently, the rediscount rate and the bankrate were reduced to 20 percent and 21 percent, respectively.

BoU remains committed to ensuring that inflation is stable and

close to the medium-term target of 5 +/-3 percentage points to encourage savings, investments and support economic growth. BoU will carefully adapt its monetary policy stance to changing economic, domestic and external developments with the aim of maintaining core inflation within its target.

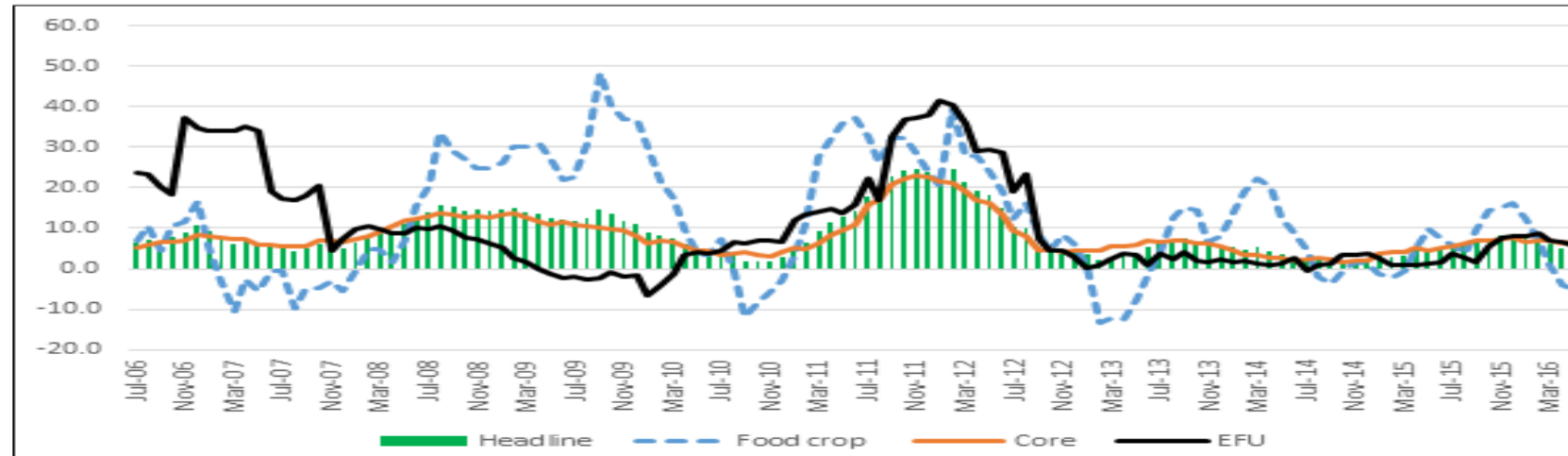
Inflation outlook in the medium term

Inflationary pressures have substantially reduced since the beginning of 2016. After peaking in December 2015 at 8.5 %, annual headline inflation dropped to 6.4 % over the last four months to April 2016. Core inflation also dropped to 6.7 % from 7.6 % over the same period.

These inflation outturns are well within BoU's medium term target of 5 +/-3 percentage points for core inflation. The decline in inflation was mainly on account of stability of the exchange rate, proactive monetary policy, continued decline in domestic oil pump prices following sustained decline in global oil prices.

In the short run, inflation could be lower albeit with occasional spouts, reflecting weather and global factors. Like any other forecast, there are risks to the inflation outlook. While external sources of inflation remain subdued, at least in the short-run, given persistently low global commodity and food prices, and weak global demand conditions, the future path of the exchange rate, which depends on the trajectory of the balance of payments and fiscal positions, in addition to other domestic and external factors remains uncertain.

Inflation by Major Groups (Year-on-Year Percentage Change, 2006 -2016) Source: Bank of Uganda Statistics



Interest Rates

The weighted average 7-day money market rate, which is the operational target of monetary Policy, trended close to the CBR for most of the first half of the financial year. This was in line with the tight liquidity conditions allowed by BOU given the risk of the exchange rate depreciation to the inflation forecast. BoU raised the CBR from 13.0 % in June 2015 to 17.0 % in October 2015, and subsequently the 7-day rate rose from 13.3 to 17.3 % in over the same period. The 7-day rate started to decline in the quarter ended March 2016, and remained relatively stable averaging 17.3 percent as conditions normalized. Figure 2 shows the evolution of key interest rates for the period March 2012 to March 2016.

Interest rates on Government securities remained elevated and close to historical highs throughout the first half of FY 2015/16. This, in part, reflected the tight monetary policy stance as well as expectations of increased domestic financing of the budget and higher inflation. The 91-day, 182-day and 364-day Treasury bill annualized yields rose from 14.6, 16.2, and 17.3 % respectively in July 2015 to 19.4, 22.8, and 22.3 % in December 2015. The yields however declined in the second half of the fiscal year to 13.54 % for the 91-day May 2016. This was partly driven by increased demand for these securities, lower inflation expectations following the monetary policy tightening, and indications that government may be reducing the domestic financing requirement for FY 2015/16.

Commercial bank interest rates rose steadily throughout the FY 2015/16 in line with the high yields on Government securities. The Weighted Average Lending Rate on shilling denominated loans moved from a weighted average of 21.8 % in July 2015 to 24.7 % in March 2016.

Overall, the high interest rates reflected the impact of the tight monetary policy stance and structural factors such as the high cost of doing business. The high interest rate environment if prolonged could further reduce lending to the private sector as demand for credit reduces and non-performing loans increase.

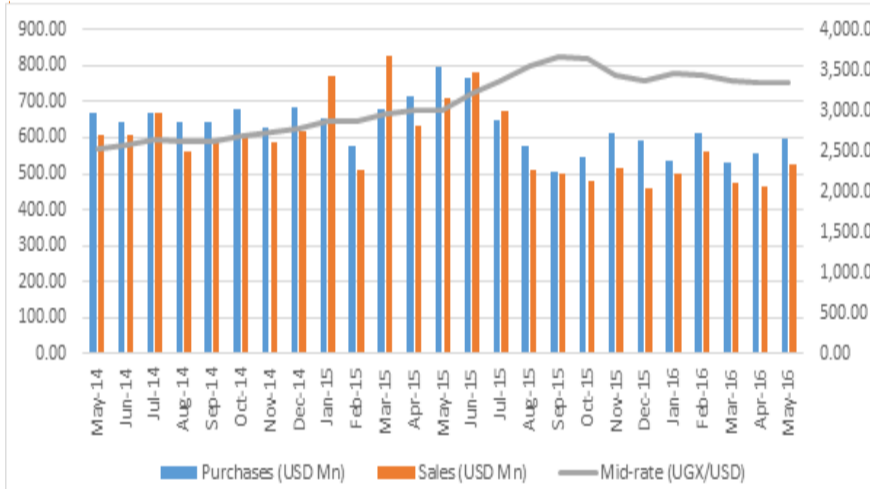
Exchange rate developments

The Uganda Shilling weakened further against the US Dollar in FY 2015/16, depreciating by 4.5 % to Shs. 3,343.6 per US dollar

in April 2016 from Shs. 3,199.9 per US dollar in June 2015. The depreciation was, however, concentrated in the first quarter of 2015/16, with the Uganda Shilling weakening by 14.6 percent in September 2015 compared to June 2015.

However, by April 2016, the average exchange rate had appreciated by 8.8 percent compared to its September 2015 level. Global strengthening of the US Dollar, elevated corporate and offshore dollar demand, weakness in the current account and sentiments surrounding an expansionary fiscal policy and election cycle at the time, all contributed to the depreciation of the exchange rate particularly during the opening months of FY 2015/16.

Supply and demand conditions in the IFEM Vs Trends of Exchange rate May 2014-May 2016



Source: Bank of Uganda

In October 2015, the exchange rate started to appreciate driven mainly by the tight monetary policy pursued by BoU that supported a pickup in portfolio inflows. Low activity in the Interbank Foreign Exchange Market (IFEM) as highlighted in Figure 3 below and a lower import bill, in part driven by declining international oil prices and delays in implementation of some Government projects, have also contributed to the strengthening of the Uganda Shilling for the larger part of FY 2015/16.

"Overall, the high interest rates reflected the impact of the tight monetary policy stance and structural factors such as the high cost of doing business".

Conclusion

The drive to stabilize the monetary policy through the CBR has to this extent been more harmful than good especially to the private sector credit. The reduction of the CBR to the current 15% will take a very long time before this reduction transmits to the lending rates that are given to the private sector by the financial lending institutions. As such, there is need 4 mining & quarrying; electricity & water; business services; community, social and other services establish a strategic bank like the Agriculture bank as this will shield the vulnerable agriculture sector from the financial market shocks. This is the only way in which we shall encourage value addition to agriculture produce ultimately increasing the value of our exports and improve the Balance of Payment.