BANK OF UGANDA

Uganda's recent experience in the conduct of Monetary Policy

July 20, 2012

1. Change to flexible inflation targeting using CBR .

"We didn't abandon monetary aggregates, they abandoned us." Gerald Bouey (1983)

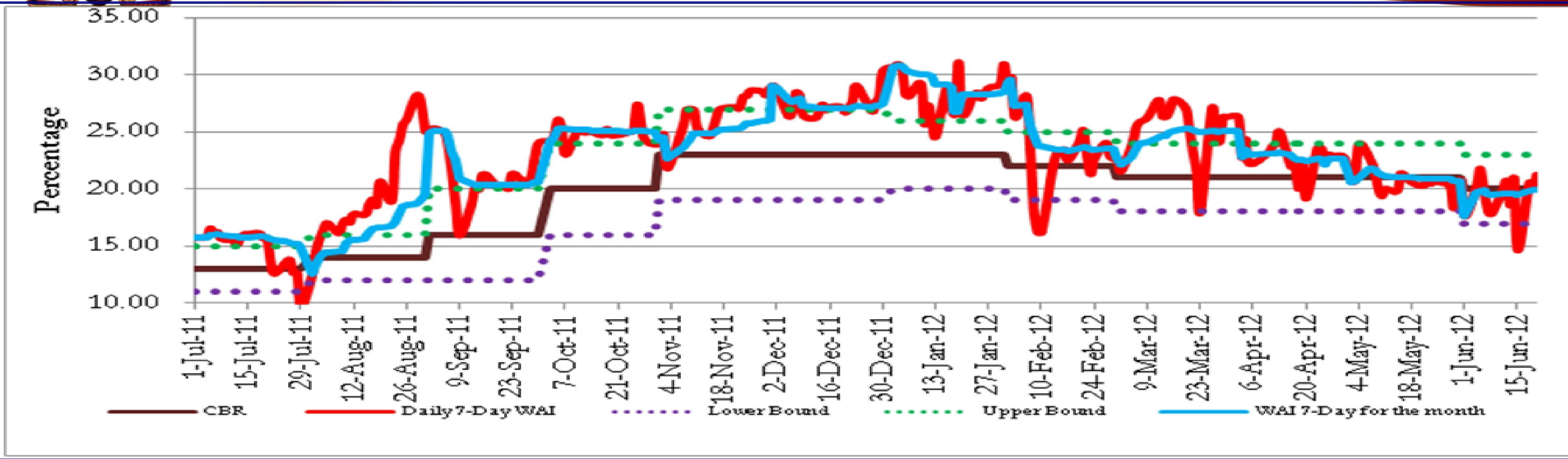
In July 2011, BoU moved away from the monetary target as anchor for monetary policy to short-term interest rates.

The relationship between base money and inflation and economic growth become increasingly unstable.

The signalling of monetary policy to the market and public had been hindered not only because of the difficulty in understanding base money for the public in general, but also due to perceptions of dual nominal anchor, i.e. the base money target and inflation target.

The monetary policy response tended to be backward-looking and more difficult to implement, considering a monetary policy time lag. Base money was more difficult to control due to the dominant role and unpredictable behaviour of currency demand.

Inflation lite regime: interest rates have closely tracked the CBR.



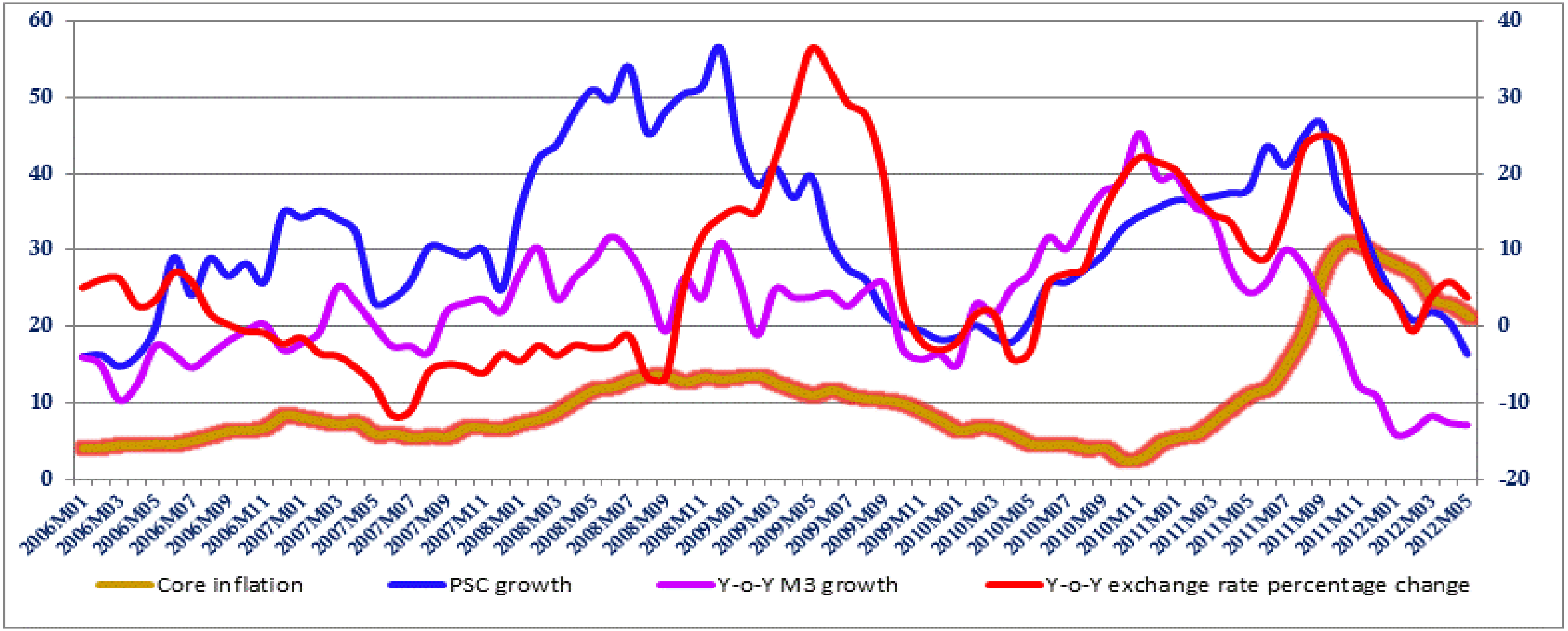
	CBR	7-day interbank	Interbank Rate	91-day Treasury bill	364 -day Treasury bill	Lending Rates
Jul-11	13.00	15.32	13.20	14.24	15.34	21.72
Aug-11	14.00	16.51	18.54	15.95	16.92	21.31
Sep-11	16.00	20.11	19.68	17.23	20.14	23.34
Oct-11	20.00	20.11	23.39	21.23	23.71	23.55
Nov-11	23.00	25.29	23.83	22.24	23.93	25.97
Dec-11	23.00	27.42	26.68	22.89	22.41	26.71
Jan-12	23.00	28.55	26.21	23.14	24.51	27.25
Feb-12	22.00	23.52	19.23	19.70	18.98	26.83
Mar-12	21.00	25.03	21.85	17.31	19.40	27.58
Apr-12	21.00	22.68	21.29	18.10	20.26	26.14
May-12	21.00	20.69	18.70	18.23	20.17	
Jun-12	20.00	19.92	17.65	18.55	19.30	

2. Domestic Economic Developments: *Inflation*

The greatest attributes of the inflation lite monetary policy framework are the fact that it is forward looking and manages inflation expectations through communication of the monetary policy stance.

However, its effectiveness can be limited by structural issues such as banks' credit limits, lumpy liquidity injection by the Treasury, market size and developing financial intermediaries.

2. *Domestic Economic Developments: Inflation*



Headline inflation rose from 3.1% in Dec10, peaked at 30.5% Oct.11 and has declined to 18% as of Jun12. Core rose from 4.8%, peaked at 30.8% and has declined to 19.5%.
Exch rate depreciated by 22%; PSC grew by 39% and M2 by 26%

2. Domestic Economic Developments: Inflation

	Mar-12	Apr-12	May-12	Jun-12	Average Jan-June 2012	Average Jan-June 2011
Annual						
eadline	21.1	20.0	18.6	18.0	21.5	11.4
ore	23.6	22.8	21.2	19.5	23.6	8.7
FU	20.2	14.3	14.5	12.9	18.1	9.8
ood Crops	10.1	9.1	8.0	11.2	12.2	26.7
ood	15.4	15.0	13.7	12.7	18.6	22.6
on Food	23.7	22.3	21.0	20.4	22.6	6.4
everages and tobacco	23.6	23.2	25.1	25.4	24.4	9.7
lothing and footwear	39.0	34.9	27.1	19.0	34.4	15.7
ent, Fuel and utilities	31.8	29.1	27.0	25.7	30.5	8.3
.hold and personal goods	24.5	22.3	19.5	18.4	23.3	16.9
ransport and communicatio	24.1	20.8	20.4	17.5	20.1	-13.0
ducation	14.9	14.7	14.3	18.2	14.6	6.0
eath ,entert. & Others	19.2	19.4	19.0	17.9	19.5	12.8
Monthly						
eadline (Monthly)	0.4	2.0	-0.1	-0.5	0.6	1.9
ore	-0.8	1.2	0.2	0.5	0.3	1.6
lec, Fuel & Utilities (EFU)	-0.5	-3.7	0.6	-0.3	1.5	1.2
ood Crops	6.5	7.6	-1.5	-5.1	2.0	3.5
ood	1.1	5.5	-0.1	-3.4	0.5	3.6
on Food	-0.2	0.3	0.0	0.8	0.7	1.0

2. Inflation outlook

Headline inflation at 18% as of June 2012 and Core inflation at 19.5 % are still high.

This disinflation partly reflects tight monetary and fiscal policies as well as the dissipation of the effect of drought, global commodity prices and exchange rate depreciation.

Inflation is projected to moderate through 2013 to a level close to BoU's target 5%.

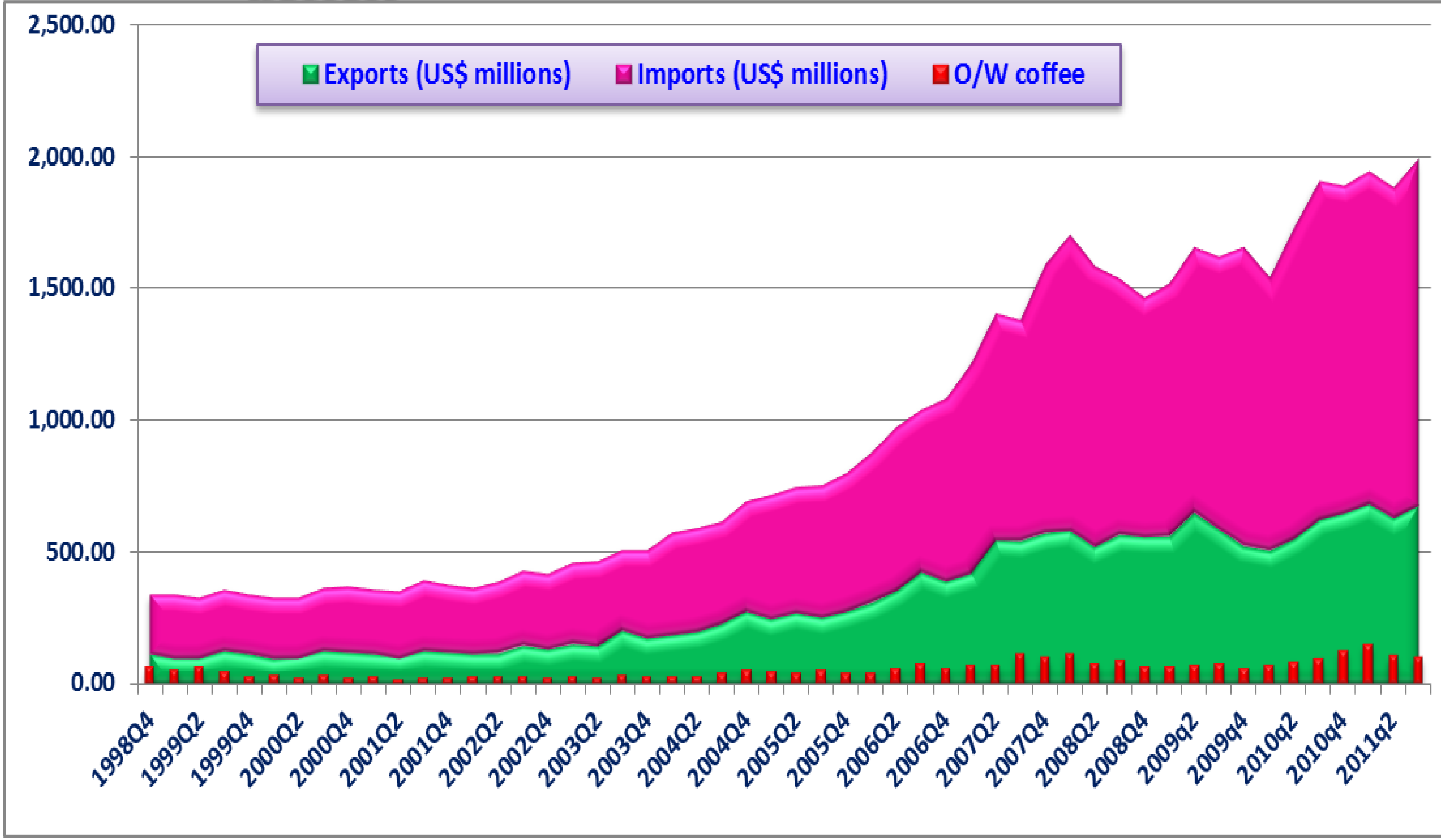
The risks and uncertainties surrounding the near-term macroeconomic outlook are still significant.

2. Effectiveness of monetary policy

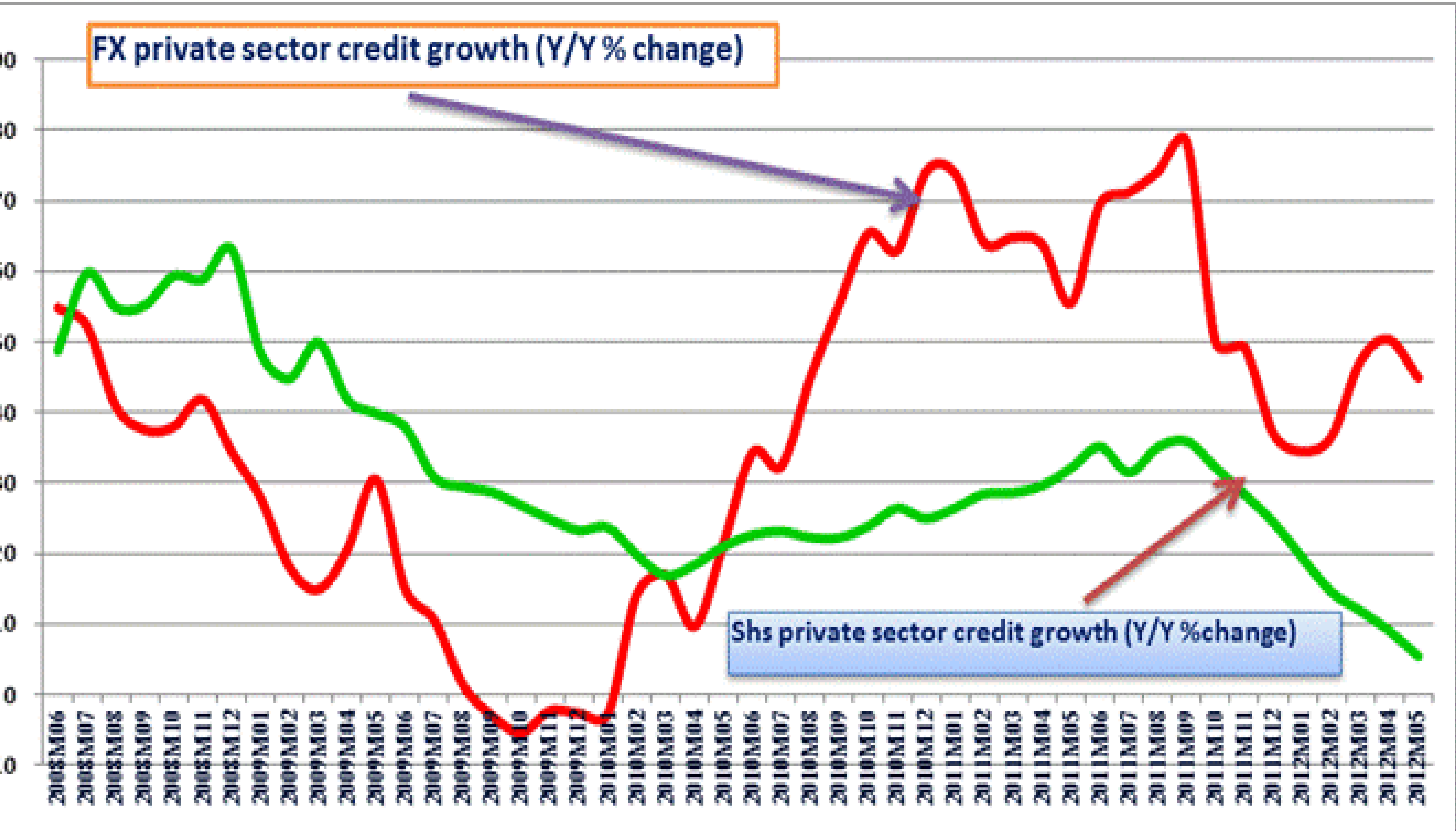
- Tight monetary policy has supported the shilling appreciation- (app by 11% btwn Oct11 and Jun12)
- The exchange rate appreciation has helped to reduce inflationary pressures. Imports including fuel have become cheaper.
- The disinflation costs have been high: economic growth has slowed down significantly:

High inflation → Tight policy stance → High interest rates and increased cost of borrowing → Slowing down private sector investment and growth.

3. Exchange rate remains a concern due to trade deficit- the terms of trade have deteriorated



Interest rates on FX loans lower than on shs loans



3. Global developments and the exchange rate

Trade:

- Slower demand in Europe = lower export volumes
- For natural resource producers, lower commodity prices = lower export prices –on average 23% of Ug's exports go to Europe

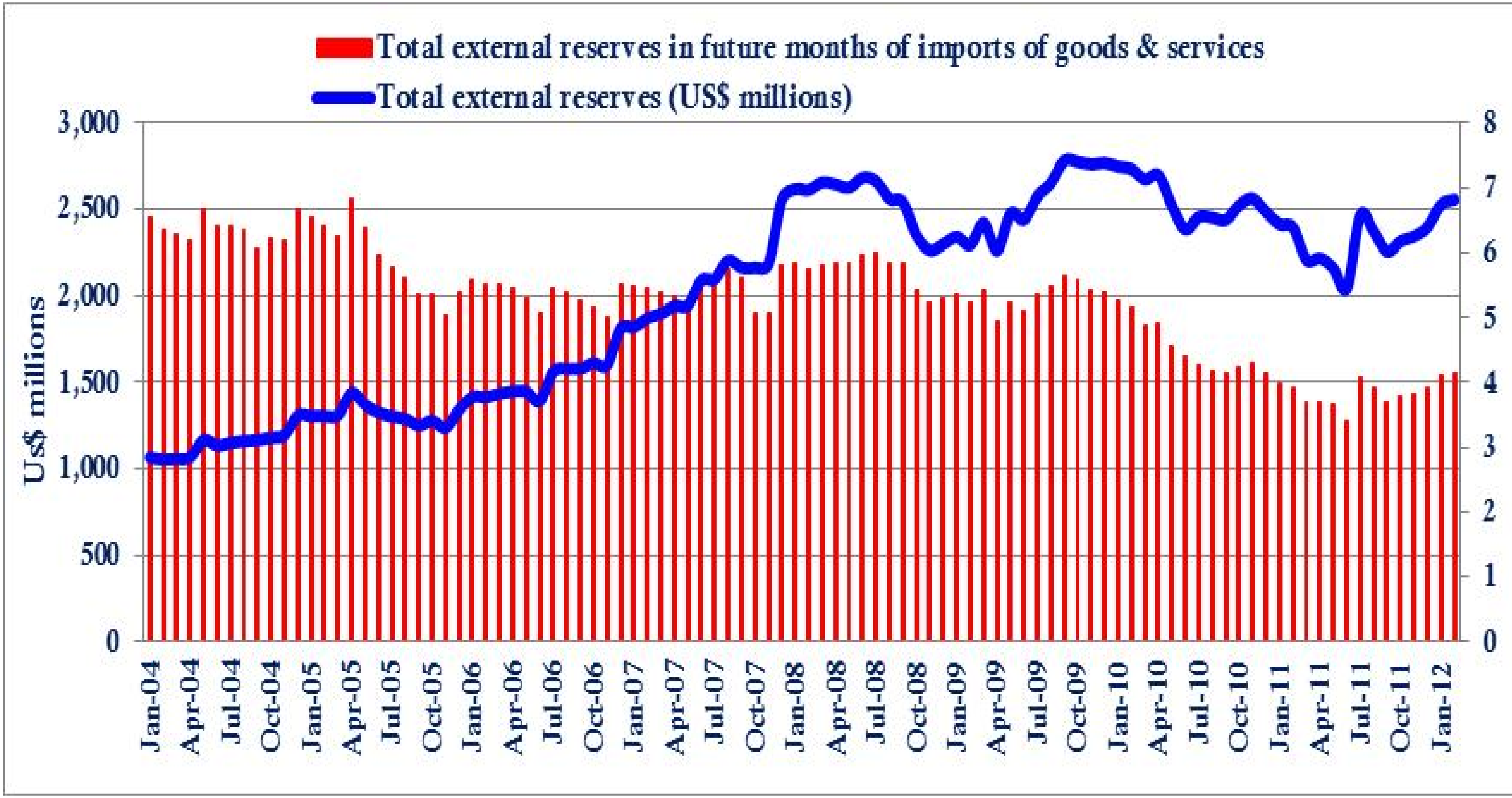
Private inflows:

- Reduced remittances (about 45% from Europe &US)
- Tighter lending conditions
- Less foreign direct investment (35% from EU) but high short term flows-offshore dominate daily FX market with a share of about 40%

Public inflows:

- Weaker donor budgets = less aid
- More expensive to tap international financial markets

3. Exchange rate remains venerable due to current account deficit-reserves have fallen modestly in months of future imports (infrastructure imports are large)



Challenges to monetary policy: is one target optimal?

When the CBR is raised to restrain domestic inflation, it strongly impacts the exchange rate, as we have experienced this since Nov 2011.

But the impact of the reversal of the short term flows could be worse.
How to conduct monetary policy to mitigate such possible effects if combined with domestic supply side inadequacies, global economic slowdown and financial volatility and at the same time support the domestic economic activity!.

Conclusion

The economy seems to have rebounded in the last quarter but it is still below potential. Consumer demand, which accounts for approximately 80% of GDP, could remain subdued in 2012 and 2013, given the households' deteriorating income position, significant credit constraints, sticky inflation and fiscal tightening measures.

Current account deficit is wide, suggesting that exchange rate could depreciate since capital inflows are likely to remain subdued. But this also points to the need to focus on exports competitiveness. Fiscal space could need to be widened because of infrastructure needs.

With economic activity still depressed, inflation expected to continue decelerating, aided by easing international oil prices, BoU is to support growth by cautious easing of monetary policy.

The uncertain global environment, could again weigh on the shilling, setting off a negative feedback loop of external and fiscal deficits, capital outflows and inflation.