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Monetary policy and economic growth dynamics in Uganda

Abstract

This paper provides an overview of Uganda's economic, monetary and financial reforms – since Uganda's independence in 1962. It traces the economic and monetary performance over the years; and it highlights the challenges facing the performance of monetary policy. In particular, the study tries to assess the main features of Uganda's monetary regime, and the associated economic performance from 1962 to date (May, 2014). Over the years, Uganda has shifted from direct controls of interest rate and credit to base money targeting during the 1990s as agreed under the IMF/WB structural adjustment programes. Since June 2011, the country has moved from monetary targeting to inflation targeting lite. Better economic management, including monetary policy since the early 1990s, has led to significant economic and financial performance – manifested in the form of high growth rates, low inflation, and steadfast growth in money supply and private sector credit. However, the performance of monetary policy still faces a number of the challenges, including fiscal dominance, monetary-policy-competing objectives and shallow financial markets. In order to overcome these challenges, the study recommends that the country reduces its over-reliance on monetary policy, in order to achieve competing goals, to improve the effectiveness of monetary and fiscal policy mix, to continue to improve its analytical capacity – by further strengthening of the legal and institutional framework for economic policies.

Keywords: Uganda, monetary policy, economic growth.
JEL Classification: E42, E52, E58.

Introduction

Uganda attained independence from the Britain in 1962 and has since recorded as many policy changes as regime changes. In particular, prudent macroeconomic management and economic reforms, including better monetary policies experienced since the early 1990s, have contributed to an improvement in macroeconomic performance in Uganda; this has manifested in the form of higher real GDP growth, and lower inflation.

Monetary policy reforms are necessary but not sufficient, especially when the monetary transmission mechanisms (MTMs) are weak. Monetary transmission mechanisms have been found to be relatively weak in low income countries (LICs) compared to the most developed countries (Mishra et al., 2010, 2012). A number of factors arguably explain the strength of the MTMs in LICs and these are but not limited to: the operational and institutional independence of the Central Bank, the country's financial structure including the level of competiveness and the size of the financial sector, degree of development of the financial sector including the development of the secondary markets, the level of financial innovations, degree of financial integration with the international markets, and the exchange rate regime.

Empirical studies have shown that a nation that has a strong independent central bank operating in a strong institutional environment, operates a flexible exchange rate system, has a well-regulated and developed financial system, including the development of secondary markets, and has a large competitive financial sector will likely have strong monetary transmission mechanisms (Mishra et al., 2010). Strong transmission mechanisms reinforce the credibility of the central bank policy announcements and accountability, increasing the likelihood of reaching its ultimate targets.

This paper provides an overview of Uganda's economic, monetary and financial reforms, since Uganda's independence in 1962. It traces the economic and monetary performance over the years; and it highlights the challenges facing the performance of monetary policy.

The rest of this paper is organized as follows. Section 1 outlines the main features of Uganda's monetary regime and the associated economic performance between 1962 and 1986. Section 2 explores the monetary regime and the associated economic performance from 1987 to date (2014). The financial structure is presented in section 3. Section 4 highlights the challenges to the effective performance of monetary policy in Uganda. The last section provides the conclusions reached and policy implications.

1. Monetary policy regime and economic performance (1962-1986)

Uganda, a small open economy, attained its political independence in 1962. Since then, it has been characterized by several macro-economic policy shifts. The conduct of monetary policy was vested in the East African Currency Board shared with Kenya and Tanzania. During the period between 1962 and 1966, the monetary policy had a limited function in the management of the macro-economy, because the country operated under the East African Currency Board (EACB). In 1966, the main roles and functions of the EACB became vested upon the Central Bank, namely the Bank of Uganda (BoU), formed under the Bank of Uganda Act (1966). It became operational in August 1966, mandated to issue and manage the Uganda shilling (Musinguzi and Katarikawe, 2000).

Post-independence Uganda was characterized by political and social crisis – right up until the early 1990s. The political instability of the 1960s included the suspension of the Constitution, and the prime minister then assuming the supreme power of government. The political environment has ramifications on the macroeconomic stability. The State held a dominant stake in the financial sector; and as a whole, the system was tightly regulated and taxed through administered interest rates and directed credit, in addition to high legal reserve requirements. Real GDP grew at an average rate of 4.8%; and annual inflation – despite going into double digits between 1965 and 1968 – averaged 4%. The double-digit inflation can, in part, be explained by the exponential growth in credit in the late 1960s (see Table 1).

Table 1. Selected economic indicators

Year	Real GDP growth rate (%)	Inflation (GDP deflator)	M1 growth (%)	Growth in credit to Government (%)	Growth in domestic credit (%)
1960	3.2	1	-	-	-
1961	-1.1	2	-	-	-
1962	4.1	-6	-	-	-
1963	11.7	7	-	-	-
1964	7.5	9	-	-	-
1965	0.9	17	-	-	-
1966	6.3	-11	-	-	-
1967	5.1	5	8	-	-
1968	3.2	15	21	35	22
1969	11.7	3	10	77	13
1970	0.7	2	14	77	23
1971	-0.2	4	2	64	26
1972	1	8	36	55	35
1973	-1	24	38	49	37
1974	-2	57	43	35	34
1975	-2	20	8	24	18
1976	1	46	37	33	27
1977	-1.6	89	30	15	25
1978	-5.5	36	21	30	24
1979	-11	216	52	28	23
1980	-3.4	150	31	59	64

Source: Background to the Budget, UBoS Statistical Abstracts, International Financial Statistics and World Bank Data (various issues).

The growth rate was supported by the national savings rate at an average of 13.4% of GDP and national domestic investment at an average 13% of GDP. The manufacturing sector was also a critical growth driver, and industrial output accounted for 14% of GDP in 1971 (Kuteesa et al., 2006).

In 1971, a new government came into power through a military coup, and this was followed by a sequence of political, social and economic mismanagement. Coupled with the external shocks, the economy encountered major economic imbalances. The economic situation of the 1970s worsened, mainly due to the poor domestic policies, including the restriction of government sharing in companies to 49%, the demise of the EAC, expulsion of the Asians in 1972 and the associated economic sanctions against Uganda. Negative real GDP growth rates were recorded from 1973 through to 1980, as shown in Table 1.

Fiscal deficits continued to rise as a result of increased military expenditure and the deficits were funded by printing money. As a result, monetary policy continued to be subordinate to the fiscal pressures. The weak legal system, coupled with increased government borrowing led to the crowding out of the private sector. The government borrowing accounted for about 70% of domestic credit (Musinguzi and Katarikawe, 2000). The state continued to carry out direct controls on credit, interest rates, agricultural commodity prices and exchange rates. The control of the latter led to the shilling being overvalued, which arguably had an impact on export volumes declining.

The financial system was weakened, with limited competition for loans and deposits. The government controlled the banking system in terms their spread and operations, with government stepping in to meet the credit requirements of some firms. Banking deposits were unattractive as a result of financial repression, and consequently the number of commercial bank branches reduced by 71% in ten years to 84 banks in 1980. Banking services became increasingly concentrated to a few banks and the largest commercial bank –Uganda Commercial Bank at the time – was government-owned (Mugume, 2006).

The 1980s, however, became the period of major economic reforms in Uganda under the auspices of

the IMF/World Bank (WB). With respect to the financial sector, the government set specified limit on: net bank credit to government, monetary growth, public spending, and the overall fiscal stance.

In June 1981, Uganda adopted its first structural adjustment programe, with the support of the IMF and the World Bank. This policy package included price liberalization, devaluation, trade-policy reforms, public enterprise, and fiscal reform, including reduced subsidies and the rationalization of public spending (Barungi, 1997). Consequently, the aggregate output recorded a growth – during the period of 1981-1983 – averaging 5.5% per annum (Maehle et al., 2013). The IMF standby arrangements went off-track during the Economic Recovery Program (ERP) in 1984 mainly due fiscal slippages. In an effort to restore macroeconomic stability, a managed float-exchange rate and a dual exchange rate were merged in May 1984, before reverting to a fixed exchange rate regime in 1986 (Atingi-Ego and Sebudde, 2000).

Between 1970 and 1986, the economy encountered a significant economic decline, manifested in slow or negative growth rates, negative real interest rates, and declining financial growth. Over this period, Real GDP per capita declined by 38%, M2 as share of GDP fell by 50% and inflation rose to 200% in 1986 (Brownbridge, 1998).

The economic retardation was attributed to domestic and external shocks. In particular, the main domestic shocks were mainly poor economic policies and the political instability over the years. There was an increased level of fiscal dominance[1], rendering monetary policy inept. Monetary policy conduct was through direct controls on credit and interest rates and the reserve requirements were kept at the same level despite the prevailing circumstances. As a result, inflation rose to double digits and triple over this period leading to real negative interest rates – consequently leading to excessive bank credit (Musinguzi and Katarikawe, 2000). The IMF structural adjustment programe adopted in 1981 and reinforced in 1984 were not successful in reversing the economic imbalances. In fact, GDP growth averaged -0.4% between 1983/84 and 1985/86 (Kuteesa et al., 2006).

2. The Monetary environment in Uganda (1987-to date)

In 1987, the IMF resumed the Structural-Adjustment Programme (SAP), which was aimed mainly at reducing inflation and restoring the sustainable balance of payments. In the financial sector, the Economic Structural-Adjustment Program

(ESAP), was aimed at increasing the competition in the financial sector, and at increasing the range of financial instruments through an expanded financial infrastructure. It also targeted the deregulation of interest rates, improving the overall process of financial intermediation, mobilization, and the allocation of resources. Other targets of the ESAP included: The removal of price controls and import licensing, as well as the progressive decontrol of foreign-exchange management (Atingi-Ego and Sebudde, 2000).

However, most of the structural adjustment financialliberalization policies initiated in the early 1980s aimed at restoring the macro stability did not fully happen until the 1990s (Kasekende and Atingi-Ego, 1996). Macro-economic stability was not attained until 1992, five years after the adjustment process was agreed upon by the IMF and the World Bank. Inflation and the growth in the annual money supply remained above 100%; and the average domestic financing over these five years was only 1.2% of GDP (see Table 2).

Table 2. Macroeconomic indicators

	Average (1986/87-1991/92)
Average end-period inflation (% per year)	107.6
Growth in average money supply M2 (% per year)	105.5
Domestic financing of the budget (% of GDP)	1.2
GDP growth rate (% per year)	5.7
Money supply M2 (% of GDP)	6.3

Source: Uganda Bureau of Statistics and Bank of Uganda Quarterly Reports (various issues).

In 1990, the liberalization of the exchange rate commenced with the legalization of the Foreign Exchange bureaus and the adoption of the foreign exchange auctions. In 1991, the Treasury bill market changed to a system through which interest rates were market-determined. Controls on government expenditure were instituted in 1992, creating monetary space to control inflation and rebuild the Foreign Exchange reserves (Mikkelsen and Peiris, 2005).

Prior to 1993, Uganda maintained strict restrictions on both current and capital account. The interest rates were fully liberalized in July 1994, while the capital account of its balance of payments was liberalized in July of 1997. Since then, there have been no restrictions on capital movements – in or out of Uganda. The capital markets authority and the Uganda securities were established in 1996 and 1997 respectively. These, combined with no-restrictions capital markets, opened doors for the external players to invest in the Uganda securities (Obwona et al., 2006).

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[1] Fiscal dominance may be defined as a situation which the government adopts a fiscal stance that is incompatible with sustaining low inflation without recourse to distortionary fiscal measures (Adam, 2009).

Under the Bank of Uganda statute of 1993, the Bank of Uganda was mandated with the exclusive responsibility for monetary policy and consequently the Reserve Money Program (RMP) was adopted, abandoning the post-independence monetary framework of direct controls. The reserve money became the operating target and set, premised on the macro-economic targets of inflation, economic growth and balance of payments (Opolot et al., 2013).

A change of the reserve requirement of commercial banks, and the issuing of Treasury bills were the available monetary policy instruments in the 1990s. In addition, BoU retained the control of the rediscount rate, when the interest rates were liberalized. The uncompetitive segment of the commercial banking sector with excess liquidity implied that changes in the rediscount rate had only a limited impact. In the mid-1990s, the Central Bank was unwilling to change the reserve requirements, because several of the small banks were too fragile to comply – without becoming bankrupt. This neutered the reserve requirement instrument (Kuteesa et al., 2010).

Following the freeze of domestic borrowing in 1992, the main aim of the sales was to develop the capital markets – especially the secondary market. However, in the 1990s, there remained virtually no secondary trading of the Treasury bills – limiting the role of Treasury bills as a monetary instrument. The Treasury bond became an instrument of monetary policy in 2004 (Kuteesa et al., 2010).

Despite the economic reforms for almost a decade, the weakness of the financial sector in Uganda remained evident in the numerous bank failures in the mid-1990s. Following the two-year moratorium instituted against licensing any new banks, the number of banks that had increased from nine in 1991 to 20 in 1996 reduced to 15 when a number of commercial banks became insolvent between 1997 and 2000, while government continued to divest its shares in the commercial banks.

The Bank of Uganda, however, responded by firming up its oversight role on the commercial banks through stringent and prudent enforcement of the Financial Institutions Act, 1993. The new Financial Institutions Act, as amended in 2002, aimed at reinforcing the strengthening supervision and regulatory roles of the Central Bank; and subsequently a Micro Finance Deposit-taking Institutions Act of 2003 was set up, resulting in the licensing of four micro finance institutions to take deposits (Opolot, et al., 2013). In addition, the bank established the Financial Stability Department in July 2009 – to analyze and monitor systemic risks to the financial system (Opolot et al., 2013).

In 2009, the RMP was modified, and a flexible version of the RMP was adopted, with Net Domestic Assets (NDA) as the operating target; and in July 2011, the RMP base-money targeting was replaced by "*Inflation Targeting Lite (IFL)*". The most important consequence of the change in monetary policy regime is that the operating instrument for monetary policy became an interest rate (the central bank rate, or CBR), rather than the monetary base.

Under the new regime, an interest rate is the operating target of monetary policy (the CBR), which is set monthly and used to guide 7-day interbank interest rates. A corridor around the CBR is also defined – to signal the allowed deviations of the interbank rate from the policy rate; furthermore, its width is frequently adjusted. The rediscount policy is also often used by the BoU to signal policy.

The monetary policy objectives, even with the adoption of inflation-targeting lite, continue to achieve low and stable inflation, boosting economic growth through enhanced private sector credit and improving balance of payments (see Table 3). Price stability continues to be the primary objective and would take precedence over the others in case of conflict. These objectives are reported on through monthly monetary policy statements, which are likely to strongly guide the private expectations of these key variables.

Table 3. Monetary policy framework

Country	Monetary policy framework	Monetary policy mandate	Monetary policy instruments
Uganda	Inflation-targeting lite	Price stability, economic growth, and financial stability	Policy rate, foreign-exchange intervention, rediscount policy and open-market operations

Source: See Bank of Uganda and IMF Regional Economic Outlook (2014).

In November 2013, Uganda signed the East African Monetary Union Protocol. All the partner States should conclude the ratification of the Protocol by July 2014. Uganda has experienced growth acceleration over the last two decades, enjoying an average annual real growth rate of 7% from 1991 to 2011. Clearly, increased private investments were needed over the years; and thus, government has also continued to be a major contributor to economic growth (Figure 1).

The high growth patterns have been followed or associated with increased monetization, financial deepening, and controlled levels of inflation over the past two decades (see Figures 2 and 3). The

estimated multiplier, and the velocity, have over the years been unstable in the short run (Davoodi et al., 2013). Figure 4 also shows that the interest rate spread (i.e. the difference between the lending rate and the savings deposit rate) has remained high.

The high interest rates in Uganda are in part explained by the oligopolistic nature of the banking sector, the size and competition of the formal financial sector, coupled with the restrictive monetary policy choices (Adam, 2009).
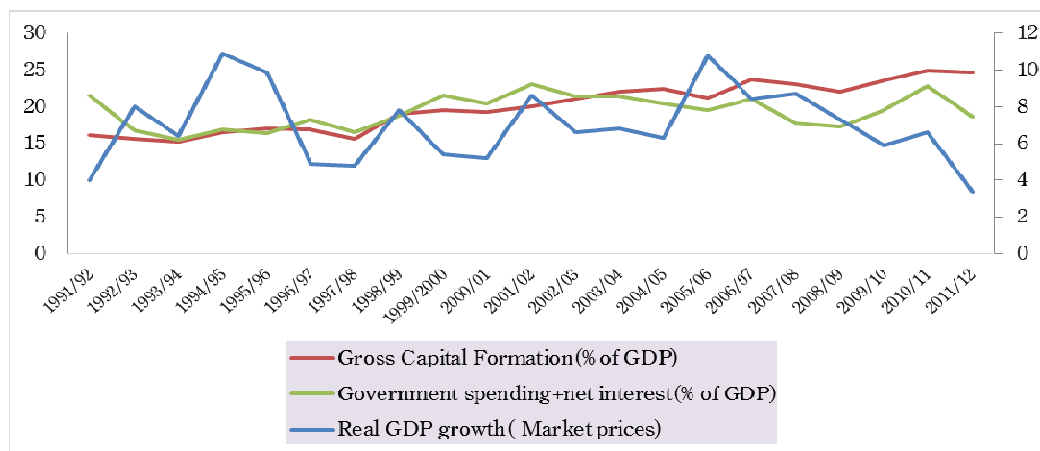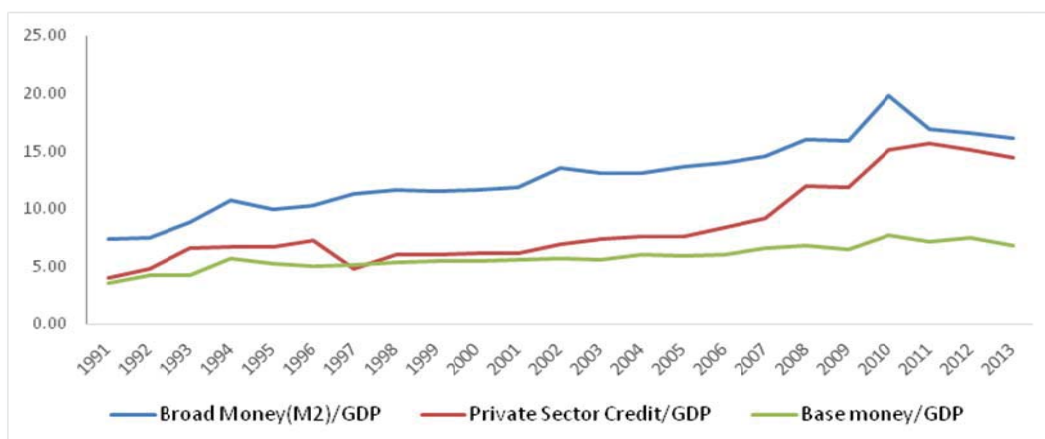

Source: BoU and Uganda Bureau of Statistics (UBoS).

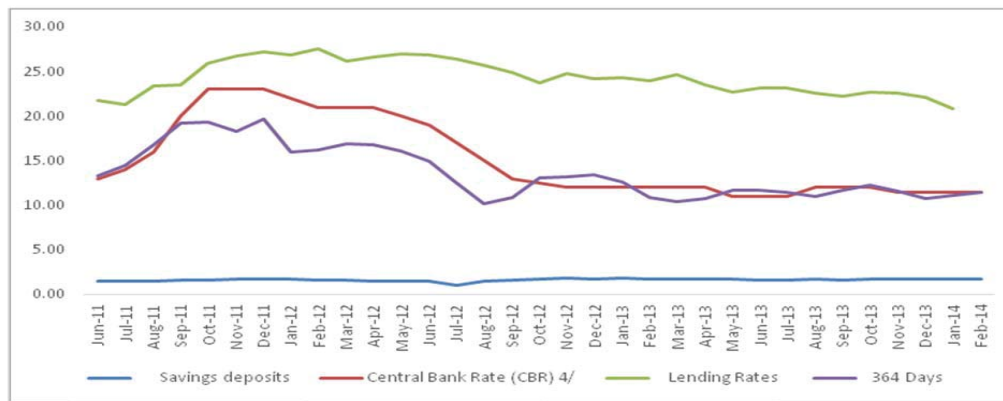**Fig. 1. Real GDP growth, gross capital formation and government spending and net lending**
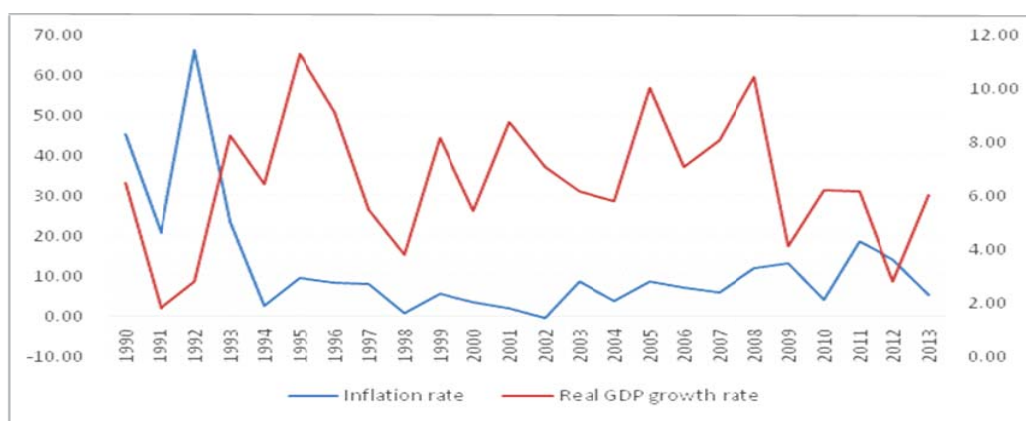
Source: BoU and UBoS.

Fig. 2. Inflation and real GDP growth rate

Source: BoU and UBoS.

Fig. 3. Financial development indicators (% of GDP)

Source: BoU.

Fig. 4. Interest rate structure

3. Uganda's financial structure

Uganda's financial system is characterized by small and concentrated private bank-dominated financial systems, a large informal financial sector, shallow capital markets, short-yield curves, and more recently increased dollarization. According to the Bank of Uganda statistics, the foreign currency deposits – as a share of total deposits in the banking system – account for 33.8%. This is higher than the IMF 2011 estimates of LICs, and the HIC share of 12.8% and 0.4%, respectively (Berg et al., 2013). Uganda's financial system consists of the BOU, 26 commercial banks, eight (8) credit institutions, and four (4) micro-finance deposit-taking institutions, the National

Social Security Fund (NSSF), a postal bank, 25 insurance companies, two (2) development banks, 102 foreign-exchange bureaux, and the Uganda Securities Exchange. As in December 2012, the commercial banks owned about 99.98% of the total assets of the deposit-taking institutions in the financial system (Opolot et al., 2013).

Table 4 shows that access to financial institutions remains low – at 20.46%, in comparison with that of HICs. The banking industry is concentrated, with the top five banks dominating the asset share. The stock market capitalization remains low; and so is the volume of stock traded as the share of GDP. This reflects the low development of the financial markets.

Table 4. Selected financial sector indicators (2012)

	Adults with an account at a formal financial institution to total adults (%)	Assets of five largest banks, as a share of total commercial banking assets (%)	Stock market capitalization to GDP (%)	Stocks traded, total value (% of GDP)
Uganda	20.46	72.64	15.39	0.1
Low-income countries	14.35	83.14	20.80	4.9
High-income countries	93.05	79.46	58.38	70.2

Source: World development indicators (2012).

However, the Ugandan banks remain well-capitalized; and they have adequate capital buffers to withstand shocks, aided by high profits. The Leverage ratio[1], which is a new indicator of banks' capital adequacy, stood at 12.2% in June 2013, far above the minimum of three per cent, as recommended by the Basel Committee on Bank Supervision (BoU, 2013).

Over the last two decades, Uganda has experienced a significant growth of financial innovations[2]. The number of ATMs has risen to 714 in 2012 – from 25 in 2001 in comparison to 496 bank branches (BoU, 2012). There has also been the de-

velopment of Electronic Funds Transfer (EFT), the Real-Time Gross Settlement System (RTGS), debit and credit cards, and mobile money products (Opolot et al., 2013).

EFTs and mobile-money services were introduced in 2003 and 2009, respectively. EFTs can be used for both credit transfers and direct debits. Mobile Money Services (MMS) have also registered significant growth in terms of the volume of transactions, recording 92% growth between 2010 and 2012 (BoU, 2012).

3.1. Uganda's exchange rate regime and capital account. Uganda is classified by the IMF as a floating regime; and the authorities intervene in the foreign-exchange market, in order to maintain stability in the foreign-exchange market. Since 2010, the BoU has been conducting daily purchases for reserve

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[1] The leverage ratio recommended in Basel III is computed as the ratio of the average three-month regulatory Tier-one capital to total assets plus off-balance sheet items.
[2] Financial innovation is defined as the emergence of financial instruments and services, and of new forms of organization.

build-up purposes, while engaging in targeted sales occasionally when necessary (Opolot et al., 2013).

Uganda liberalized the capital account of its balance-of-payments in July of 1997 and has since then had no quantitative capital account controls on capital movements in or out of Uganda (Berg et al., 2013). Chinn and Ito (2008) created an index that measures the extent of openness in capital account transactions, a higher value of which corresponds to fewer restrictions in international transactions. According to *de jure* Chinn and Ito (2008), using the updated financial index values of 2011, Uganda scores 2.44 (see Figure 5). The index indicates that the Ugandan economy has been the most open economy in the East African Region, since it liberalized its capital account. The index rose from 0.15 in 1997 to 2.44 in 2011. By comparison, the index for the United States and the United

Kingdom in 2011 stood at 2.39. According to the *de facto* measure of the ratio of total external assets and liabilities to GDP for Uganda (see Lane and Milesi-Ferretti, 2006), the ratio has more than doubled – from 0.31 in 1991 to 0.66 in 2011 – indicating an increase in the degree of openness of the economy to international capital flows.

Portfolio investments that were nearly zero in 1999 and US$0.25 million in 2000 have increased to US$1005 million in 2013. The most significant rise was from US$335 million in 2012 to the 2013 figure. This could be attributed to the return differentials within the region. The flow of FDI, which was US$55 million in 1993, has risen exponentially so that Uganda shows the highest receipt of FDI in the EAC, recording US$1.72 billion in 2012, compared to Tanzania US$1.71 billion (see Table 5).
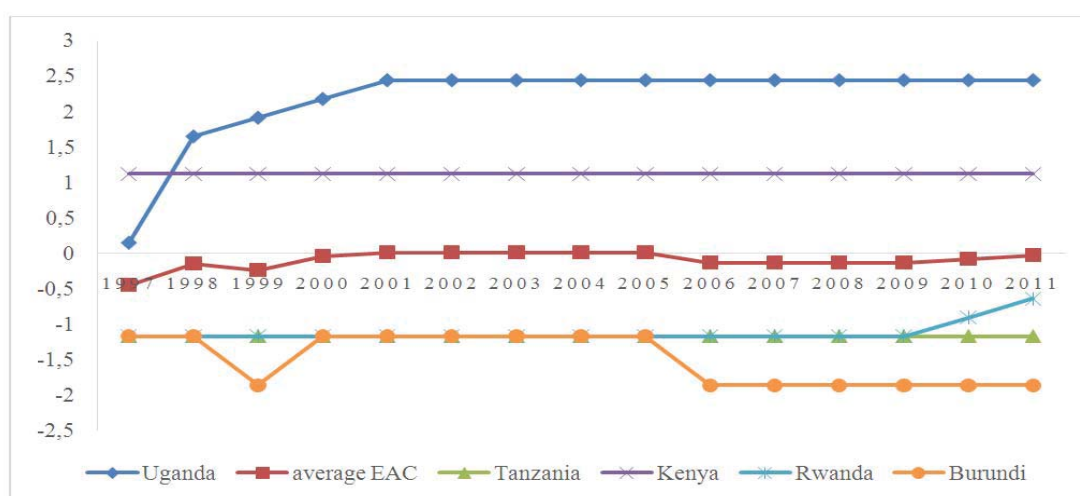
Source: Chinn-Ito Index Database (2010).

Fig. 5. Chinn-Ito financial openness index

Table 5. FDI flows to EAC (US$ billions)

	2006	2007	2008	2009	2010	2011	2012
Uganda	644	792	729	842	544	792	1720
Kenya	51	729	96	116	178	335	259
TZ	403	582	1247	953	1023	1095	1710
Rwanda	31	82	103	119	42	106	160
Burundi	0	1	4	0	1	2	1

Source: UNCTAD World Investment Report (2013).

An alternative measure was constructed by Dhungana (2008) that excludes concessional financing and the holding of foreign exchange reserves[1]. Using the United States and Japan as benchmarks, this ratio was 2.78 for the United States, and 1.72 for Japan. For Tanzania, it was 0.53, and for Uganda, it was 0.48. Uganda has had an open capital account *de jure* since the late 1990s. However, *de facto* indicators concur in suggesting that the

country has enjoyed only a limited degree of integration with international financial markets (Monteil, 2013).

4. Challenges to monetary policy in Uganda

Uganda faces a number of challenges in designing monetary policy frameworks in a bid to achieve its objectives of low inflation and full employment output, as well as maintaining its financial stability. The constraints of monetary policy implementation include political, institutional, structural and technical factors.

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[1] The index takes a maximum value of 2.5 for the most financially open economies, and a minimum of -1.9 for the least financially open.

One of the main threats to efficacy of monetary policy is the lack of central bank independence. Over the last few years, monetary-policy costs have grown to account for 30% of the central bank's total operating expenditure[1]. This trend will probably lead to an erosion of the Bank of Uganda's capital, and to the risk of the Central Bank's independence being compromized.

Uganda has still low levels of financial development, as shown in Figure 2 and Table 4. Private sector credit, as a percentage of GDP, stood at about 15% in 2013. It is still low by regional and international standards. *De facto* indicators concur in suggesting that the country has enjoyed only a limited degree of integration with international financial markets. To date, Uganda has had no issuance of international debt securities.

Uganda's banking sector has limited competition and as shown in Table 4, the asset concentration is dominated by the five largest banks. This, according to conventional wisdom, is likely to constrain the classical interest-rate channel. In addition, Ugandan commercial bank hold substantial excess reserves to an average of 30% of the required reserves, which could serve to prevent the operation of the monetary transmission mechanism. It is sometimes argued, specifically, that excess reserves imply that policy tightening is "pushing on a string"; and it is therefore, ineffective (Saxegaard, 2006).

As previously mentioned, Uganda has enjoyed steady fast growth in financial innovations; and it is destined for more innovations in the future, with more banks likely to come on board. The commitment to the 2022-roadmap of East Africa Monetary Union should increase the potential of this trend in financial innovations. Financial innovations tend to increase the instability of the money demand through the increased velocity of money as well to change the behavior of economic agents. This is likely to strengthen the interest rate and the exchange rate channels, and weaken the credit channel (Noyer, 2001; and Weber, 2007).

In Uganda, since the monetary policy has been tailored towards targeting M2, it is likely that monetary policy will affect only the local currency, not foreign currencies. While the CBR was changed from 11% (July 2011) to 23% (November 2011 to January 2012) to curb the inflation spiral, some banks reached an extent of extending loans only in foreign currency and not in local currency. According to the Bank of Uganda Statistics, foreign deposits accounted for 33.8% of the total deposits in December 2013. This implies the more foreign deposits as share of M3, the less likely will monetary policy be effective, and this also improves the scope of cross-border spillovers (Szpunar and Głogowski, 2012).

The effectiveness of monetary policy depends on the magnitude of financial frictions, which are in part contingent upon the institutional and regulatory environment. Financial frictions tend to increase financial intermediation costs – including but not limited to – loan-evaluation costs, monitoring costs, and contract-enforcement costs. The magnitude of these costs depends on the quality of the domestic institutional environment (the security of property rights, the quality and enforcement of its accounting and disclosure standards, as well as on its bankruptcy laws, and the efficiency of the domestic system), as well as on the domestic borrowers (Mishra et al., 2010; Monteil, 2013).

According to Monteil (2013), direct measures of these factors are not available, but since they are all particular aspects of a country's general institutional environment for the performance of economic activity, more general indicators of such institutional quality are likely to be correlated with them. According to the World Bank Governance Indicators 2013, the institutional quality indicators reveal that Uganda has low rankings in the area of government effectiveness and the control of corruption. This suggests that the government-provided public goods, on which the financial system is based, may not be as readily available in Uganda, as they are in some other countries. The relative scarcity of such public goods would tend to make financial intermediation a costly activity, thereby limiting the transmission of monetary policy, and in part explaining the size of the formal financial sector.

Over the last 6-8 years, Uganda has encountered exogenous shocks – in particular, the terms-of-trade shocks (reflecting food and fuel)[2] that have posed challenges to the performance of monetary policy. Since 2003, two significant increases in world food and energy prices have been recorded (see Figure 6). The first surge took place just prior to the world financial crisis in 2008, with food prices soaring. This resulted in substantial inflation pressures in Uganda as shown in Figure 2.

The second major commodity price shock occurred in 2010-11; and the Ugandan inflation took off again, recording an annual inflation rate of 18.6% in 2011, and 14% in 2012; and subsequently, economic growth in 2012 took a tumble – recording the lowest rate in over two decades at 2.78% (see Figure 2). In the case of imported food (and fuel) inflation, as well as monetary policy, influences their output through the exchange rate and inflation.

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[1] Bank of Uganda, Annual Report, 2012/13.

[2] Oil remains the most important source of primary energy in the world, accounting for about 33 per cent of the total. The two other fossil fuels, coal and natural gas, account for 28 and 23 per cent, respectively (IMF World Economic Outlook, 2014).

Uganda has also not been immune to domestic shocks. Inflation in the last few years has soared into double figures – considerably higher than the annual target of 5%. The high volatility in inflation is attributed to the high share of food items in the overall CPI, in line with the economic structure. The domestic food prices have been largely attributed to weather patterns, which are characterized by a bimodal annual rainfall cycle.

The weight of food in the CPI in Uganda is 27%, reflecting the economic structure. The CPI survey does not include the rural households. In addition, the agricultural sector, being largely non-monetized, makes the performance of monetary policy difficult.

In Uganda, while the Central Bank has over the years managed to evade the impossible trilemma, the multiple objectives[1] have not entirely disappeared, with concerns about the exchange rate and balance of payment along with maintaining high growth rates remain high on the Central Bank's radar. The Central Bank also cannot ignore the banking system when pursuing its monetary policy objective.

While the multiplicity of policy instruments increases the credibility of the central banks, many instruments also risk having conflicting impacts; or they at least risk weakening the transmission mechanisms. This also makes it difficult to accurately interpret the exact impact of the respective instruments.
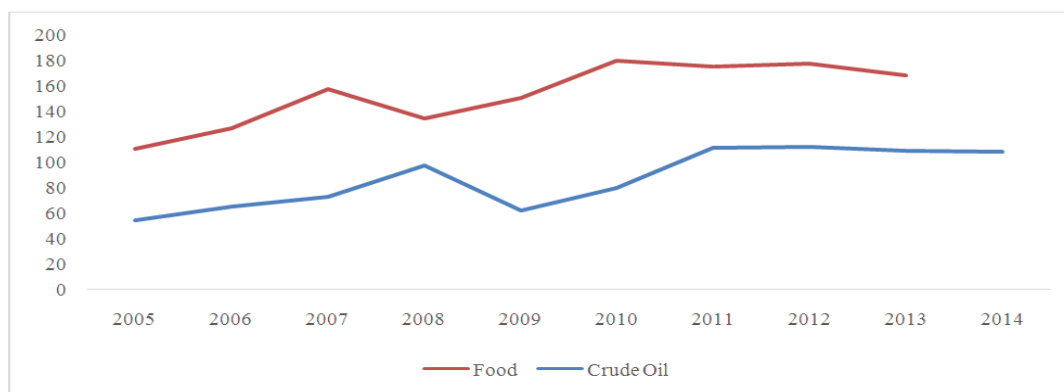
Source: International Monetary Fund; World Economic Outlook Database, April 2014.
Note: Index, 2005 = 100.

Fig. 6. World commodity prices

Increased government domestic borrowing tends to increase interest rates, crowding out the private sector and resultantly leading to lower output. This often comes in conflict with monetary policy, in trying to meet its ultimate objectives of low stable inflation and higher growth rates. Persistent fiscal indiscipline, including high fiscal deficits funded through domestic markets insubordinates the monetary policy to fiscal policy; and the expectations of economic growth and inflation are hinged on fiscal policy (Hammond et al., 2009).

Between 2007 and 2012, Uganda's domestic debt stock[1] picked up from 9% to 13.1% of GDP, while the external debt increased by 4.8% to 17.1%. The total public debt grew by 8.9% to 30.3%. The increase in the total public debt is partly due to the rising fiscal deficit (including grants). This gap is projected to widen from about 4% of GDP in 2012/13 to 5,25% of GDP in the medium term, peaking at 7,5% of GDP in 2013/14 (IMF, 2013).

Inaddition in 2010/2011, there were fiscal slippages stemming from an attempt to reverse the procyclicality of fiscal policy, as well as election-related spending. This led to domestic borrowing to the tune of 1.3% of GDP, in violation of the IMF agreed assessment target for net credit to government (IMF, 2010).

The openness of the capital account makes the economy susceptible to volatile capital flows, thereby making the performance of monetary policy complex – at the extreme, the impossible trinity of managing the volatile exchange rate amongst other monetary objectives. The problem could be magnified by the fact that Uganda also has a large informal capital account (Adam, 2009). In addition, the capital inflows are often associated with asset prices booms, especially in underdeveloped financial markets; and portfolio investments tend to be volatile, especially when there are incentives for cross-border investments. Prasad and Rajan (2008) advise against greater openness of the capital account; and they propose moderate tax on

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[1] The primary auctions of government securities are now used to fund the government domestic borrowing requirement and to refinance the existing stock of securities, as they mature rather than as an instrument of monetary policy (Tumusiime-Mutebile, 2012).

[2] In some circumstances, when the economy has faced a supply shock, as was the case in 2011, there was an unavoidable conflict between achieving both inflation and output targets. In that particular circumstance, the inflation target took precedence (Tumusiime Mutebile, 2012).

capital flows. The journey to oil production in the next few years will be associated with higher levels of both the portfolio and direct investment flows. These flows are likely to be volatile as well.

Aid, just like capital inflows, comes with an appreciation of the exchange rate; and it increases money and net domestic assets. Despite Uganda experiencing a significant decline in aid flows, such aid flows are still significant. The aid flows to Uganda have been volatile and unpredictable. In the recent past, the volatility has been strongly linked to the political and governance issues, as well as to the development of human rights movements. The sudden decline in aid could exacerbate the fiscal deficits – leading in all likelihood to higher domestic funding, as was the case in 2013/14; or at least, the inflation target could be relaxed (Adam, 2009).

The choice of monetary policy becomes complex as it has to factor in a number of elements, inter alia, higher consumption patterns, corruption and capacity to absorb the aid inflows. The shift to budget support in the mid-2000s posed exchange rate volatility and liquidity management challenges for the Central Bank, as budget support was associated with increased domestic credit creation (Brownbridge and Tumusiime-Mutebile, 2007).

While inflation-targeting lite has been successful in bringing down inflation, the transition to fully fledged inflation targeting will in part be challenging to the Bank of Uganda. The transition will require understanding the clear monetary transmission mechanisms; analytical infrastructure for a forward-looking approach to monetary policy; financial autonomy of the Central Bank; robust institutional frameworks; and enhanced capacity to successfully manage the impossible trinity. This requires the availability of good macroeconomic data to inform their decisions (Hammond et al., 2009). A key challenge is also whether the commercial banks that have excess reserves will continue to respond to the monetary policy signals.

The transition to the EAMU poses challenges to the conduct of monetary policy in the respective individual East African countries. This will require radical changes to the exchange rate policy, as well as to monetary policy.

Conclusion

Uganda has over the years shifted from direct controls of interest rate and credit to basic money targeting, as during the 1990s agreed upon under the IMF/WB structural adjustment programs. The Reserve Money Programe remained in place until June 2011, when BoU moved from monetary targeting to Inflation Targeting Lite. The economy has since the early 1990s experienced low levels of inflation and high levels of economic growth. This performance can be attributed to the legacy of a long record of sound macroeconomic policies (including monetary policy) that created a stable platform for growth. Since the dawn of economic reforms in 1986, there has also been substantial growth in the financial architecture. However, in recent years, the economy has been subjected to a number of internal and external shocks. In particular, the global terms of the trade shocks of 2008-09, associated with high global fuel and food prices. And thereafter, the global financial and economic crisis, both posed major challenges for monetary policy in Uganda.

This paper has explored a number of challenges to the effective performance of monetary policy in Uganda. In part, these are: technical, structural, institutional and political. The current monetary practice of inflation-targeting lite has generally delivered results in the short run; however, the under-developed financial sector, especially the financial markets, make the transmission of the policy objectives tricky or weak. Short-term interest rates remain a credible intermediate target; but there is a heightened need to develop and deepen the financial sector. Frequent examination of the transmission mechanisms remains critical. Increasing fiscal deficits are disruptive; and they have, in part, led to increased domestic borrowing – leading to the crowding out of private sector credit – thereby, subduing private sector growth over the last couple of years. The fiscal deficits, and in particular the segment funded by domestic borrowing, needs to be lowered to ensure an effective fiscal monetary policy mix.

While Uganda has been successful in avoiding the impossible trilemma, the transition to fully fledged inflation targeting will likely pose trilemma challenges. The openness of the capital account, the envisaged oil production-related capital inflows, and the multiple objectives undertaken by the central bank could heighten this challenge. Continuing to monitor the trends of these key variables should advise future actions and monthly communication of the policy statements. Lastly, independence of the Central Bank – both institutional and operational – is critical in the performance of monetary policy. It is even more critical with the adoption of Inflation-Targeting lite, as this enhances the credibility of the Central Bank. Recapitalization of the Central Bank, and the strengthening of independence via the Bank of Uganda Act would be essential for the transition to fully fledged inflation targeting.

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