BANK OF UGANDA

Remarks by

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Theme: The Role of the Bank of Uganda in ensuring Macroeconomic Stability

Speech Title: "*The Role of the Bank of Uganda in Fostering Price Stability and a Sound Financial System*"

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Good afternoon,

It is a pleasure and great honor to be here this afternoon to interact with you, a forum of Government Communicators. You are probably aware that it is a constitutional mandate of the BoU to formulate, conduct and manage monetary policy in Uganda, with the overall objective of maintaining macroeconomic stability, defined in terms of price and financial stability – roles that I wish to discuss in succinct detail.

It is important to reflect on history to appreciate the present. In the 1970s and 1980s, monetary policy was conducted in an environment of substantial fiscal dominance. The result was inflation peaking at around 250% in 1986/87. By the early 1990s, the evident failure of an (over) activist monetary policy encouraged moves to dismantle control regimes, liberalize foreign exchange markets and establish more robust fiscal regimes. Prior to the 1990s, interest rates were largely administratively controlled and BoU was required to abide by the doctrines of the fiscal authorities, which largely directed monetary policy to fill government financing gaps. Furthermore, parallel foreign exchange market was ubiquitous during this period reflecting exchange rate controls in a context of monetary financing of large fiscal deficits. To bring back macroeconomic stability, there were two key developments. First was the move towards more flexible exchange rate regimes and second was that price stability became the *de jure* principal aim of monetary policy.

Monetary policy is a demand management tool, thus the objective of price stability. *It should be noted that price stability is not sufficient to ensure macroeconomic stability. In addition, monetary policy cannot be used to mitigate the supply-side factors, which in effect require structural policies which are long-term in nature. It is also important to note that it is the combination of a country's fiscal and monetary policies that direct a country's economic outcomes (development agenda).*

The focus of monetary policy in ensuring stable prices recognizes both its powers and limits regarding its influence over the rest of the economy. Over long horizons, the size of the economy and its average rate of growth are driven by developments on the supply side. The impact of monetary policy on the economy also occurs with a lag. Given this limited scope for monetary policy, it is not feasible for BoU to adopt other long-run targets, such as the growth rate of economic activity.

The overall objective of BoU's monetary policy is to achieve low and stable inflation, defined by a medium-term target of 5.0 percent of core inflation. The secondary objective of BoU's monetary policy is to support growth. It is important, at this point, to also emphasize that BoU pursues a flexible exchange rate policy to ensure that the balance of payments is sustainable. Interventions by the BoU in the foreign exchange market are solely to dampen disruptive volatility in the exchange rate and not to impede exchange rate adjustments – which are necessary to maintain external balance. In so doing, BoU ensures stability in the exchange rate. The key ingredient in monetary policy decision-making involves evaluating the future projection for inflation.

Why price stability?

This is because high inflation has adverse implications for economic growth. High inflation erodes the value of incomes and savings and leads to high nominal interest rates. This is because high inflation increases the uncertainty about future relative prices and about the price level, and so domestic and foreign financial markets require a higher risk premium as compensation for this increased uncertainty. When inflation is high in the long term, inflation and depreciation expectations generally become fixed in the decision-making of economic agents. Inflation causes several other economic distortions that reduce the long-term growth potential of the economy: it redistributes income from creditors to debtors, creates distortions in the tax system, and represents a hidden burden on savers, who are unable to safeguard the purchasing power of their incomes and savings. In the presence of inflation, being efficient and competitive at the production and distribution of goods and services becomes less important to the real outcome of economic activity.

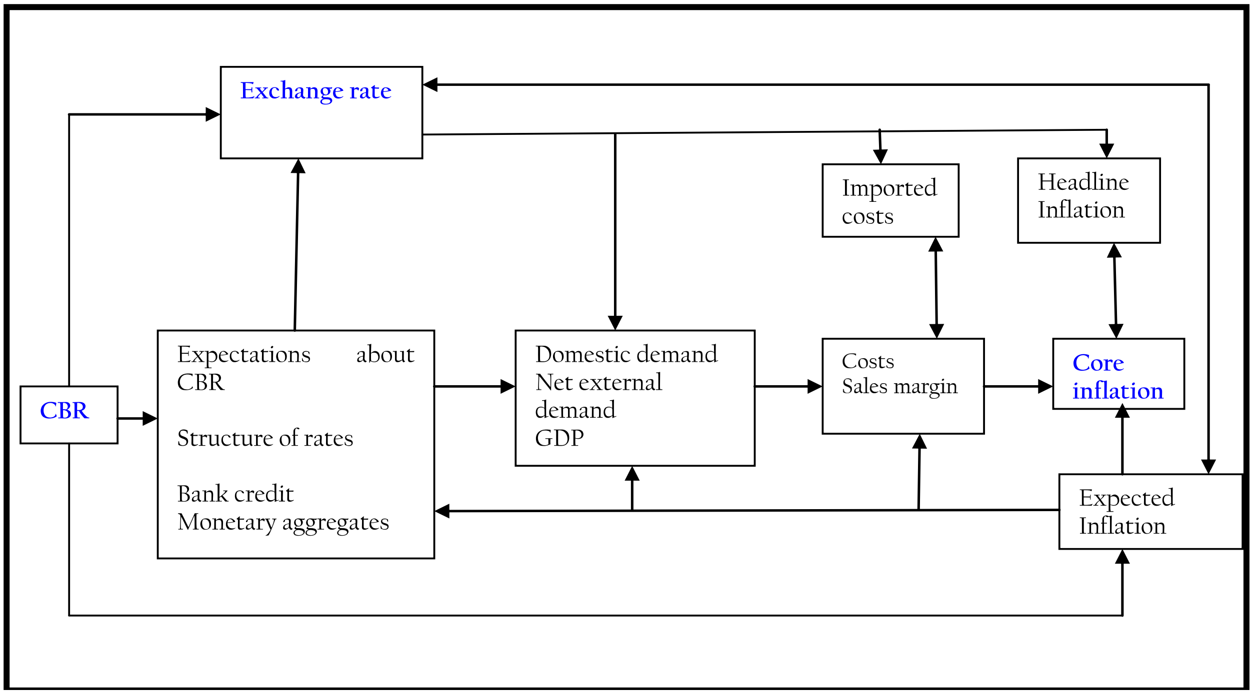
In its pursuit of the inflation objective alluded to above, BoU uses the flexible Inflation Targeting–monetary policy framework (Inflation Targeting Lite-ITL) in guiding its monetary policy operations. Inflation targeting framework entails two components: 1) a particular framework for making policy choices, and 2) a strategy for communicating the context and rationale of these policy choices to the broader public. The ITL monetary policy framework employs a policy interest rate – the Central Bank Rate (CBR) as the operating target of monetary policy. The CBR is intended to guide short-end interbank interest rates, which in turn are expected to influence other interest rates in the economy, such as commercial bank deposit and lending rates. To align the short-end interbank interest rate with the CBR, the BoU undertakes secondary market interventions to either withdraw or inject liquidity in the domestic money market - mostly through Repurchase Agreements (REPOs) and reverse REPOs.

Monetary policy is set with the future in mind. Monetary policy influences inflation with a significant lag, so when setting the policy rate the Bank takes into account its views about the likely future path of the economy. The BOU forecasts the future path of inflation and compares it with the target inflation rate. The BOU also considers the future path of the output relative to the optimal as well as the exchange rate. The difference between the forecasts and the target determines how much monetary policy (central bank rate) has to be adjusted. Rather than focusing on achieving the target at all times, the approach has emphasized achieving the target over the medium term—typically over a one-year horizon.

The CBR is set bi-monthly by the BoU's Monetary Policy Committee (MPC) in line with a 12-month outlook for core inflation, an estimate of the output gap (the difference between the economy's actual and the potential or equilibrium output) and qualitative judgments. If the MPC believes that over the 12-month forecast horizon, these considerations are tilted on the upside, it will usually raise the CBR and vice versa. Ideally, an increase in the CBR would aim to slow down demand and consequently reduce inflation while a decrease in the CBR would be intended to increase demand and boost the overall level of economic activity in the economy. Monetary policy has in recent times been overly accommodative. In the past two years to February 2018, the CBR has been reduced by a cumulative 800 basis points, from 17 percent in February 2016 to 9 percent as of February 2018.

The effectiveness of monetary policy depends crucially on the transmission of a policy change to output and ultimately to inflation. The monetary transmission process begins with the central bank announcing a policy action and engaging in open market operations to bring money market interest rates in line with the policy rate. The monetary transmission via the interest rate channel can be described as follows. The central bank raises the policy rate. First, money market interest rates will rise as a result of the central bank's open market operations. Second, the term structure of interest rates will change according to expected future short-term interest rates. Third, retail interest rates of commercial banks will rise in accordance with the term structure of interest rates. Fourth, given price stickiness in the short run, long-term real interest rates will rise. It is this final development that will slow down consumption and investment of households and firms because of the increased opportunity cost. The way BoU envisions how policy actions are transmitted to the rest of the economy is summarised in *figure 1.*

Figure 1: Monetary Policy Transmission Mechanism.



The BoU has been very successful in anchoring consumer price inflation around the BoU's medium-term target of 5.0 percent for core inflation. Both annual headline and core inflation have averaged 5.1 percent and 5.0 percent, respectively, during 2012/13 – 2016/17, and have averaged 4.5 and 3.6 percent for headline and core inflation, respectively, in the first seven months of 2017/18. The short- to medium term outlook suggests that core inflation will fluctuate within BoU's medium-term target of 5 percent, supported by an expected reduction in spare capacity in the economy, which will support a gradual increase in inflation towards the target rate. Nonetheless, there are potential risks of stronger inflationary pressures emanating from a mix of factors pertaining to the future direction of food crops prices and the path of the exchange rate, with the latter contingent on the external economic environment.

Role of communication

In a market economy, transparency and communication are central to the effectiveness of our monetary policy. First, having a clear objective supports credibility and helps anchor inflation expectations. Second, adopting an explicit monetary policy strategy helps markets and the public understand how the central bank is likely to respond to economic and monetary developments – its so-called "reaction function". Together, a credible objective and a well-understood reaction function allow financial markets and the public to form reasonable expectations about the future interest rate policy. This in turn gives us the capacity to influence interest rates at longer maturities and steer broader financial and economic conditions. This is what has been called "management by expectations".

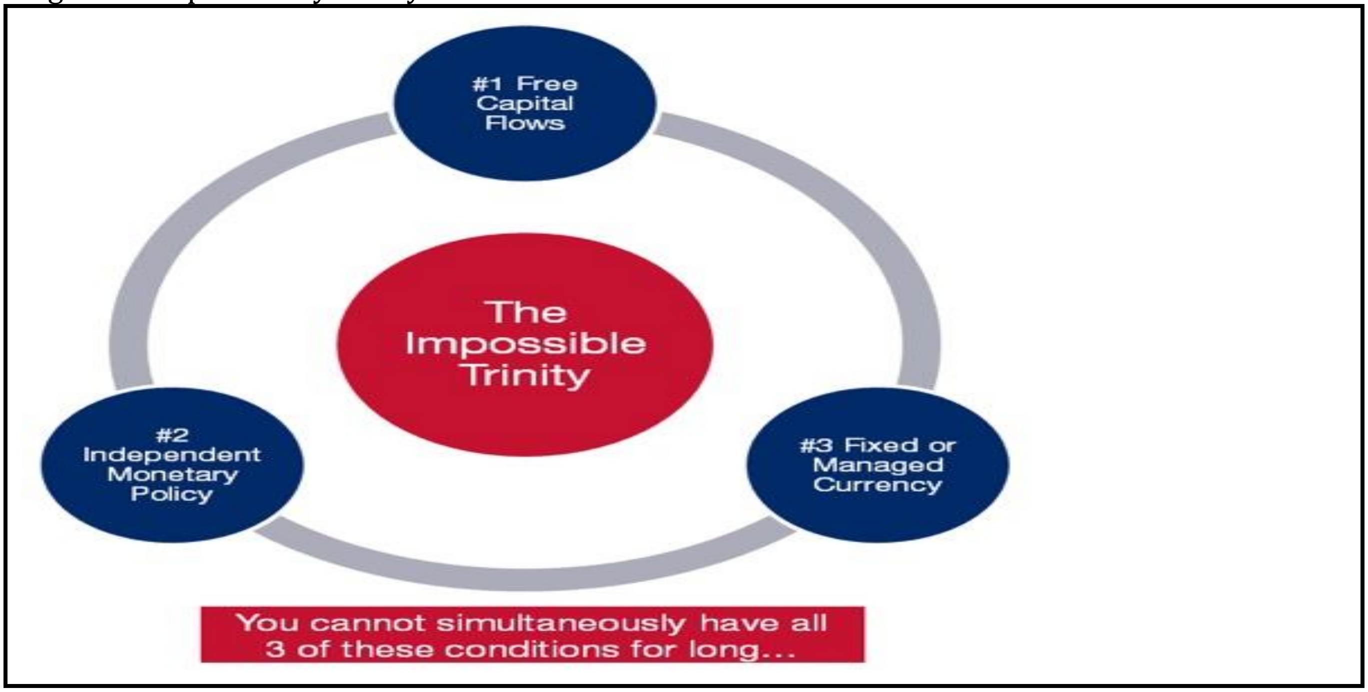
Up until 2011, BoU was rather secretive and more inclined towards locking away its reasoning. Markets had to guess what the central bank was doing. Today, however, the BoU like most central banks has realised that it is more likely to fulfil its mandates if it informs the public and the markets about its strategy, assessments and policy decisions in an open, clear and timely manner. The presumption is that market participants make more efficient decisions when markets can correctly predict the BoU's actions. In this case, the BoU's presumed objective is to raise the signal-to-noise ratio.

The role of the Exchange rate

Should the BoU be concerned about the level of exchange rate?

The fact that exchange rate fluctuations are a major concern in Uganda, like in so many other low-income countries, raises the danger that monetary policy may put too much focus on limiting exchange rate movements, even under an inflation targeting regime. '*Impossible trinity': where you are in a house that is burning, and you have the option to save only two out of three people.* A country cannot simultaneously fix the exchange rate, have an open capital account and pursue an independent monetary policy. Only two out of these three objectives are mutually consistent. The impossible trinity summarized in *Figure 2.*

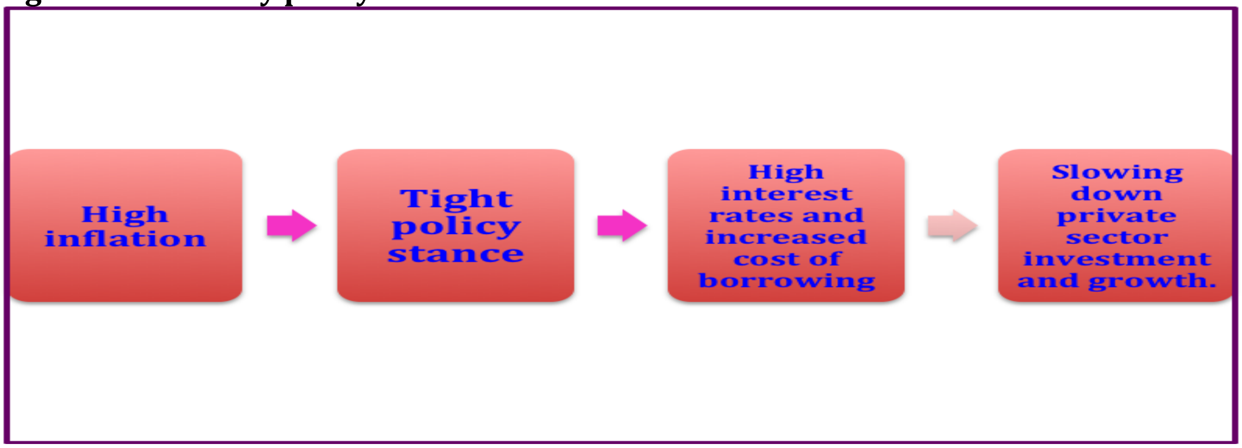
Figure 2: Impossibility trinity



Challenges to monetary policy

1. Conducting monetary policy involves budgetary costs and trade-offs as shown below in *Figure 3*.

Figure 3: Monetary policy involves costs



2. One of the main constraints of monetary policy transmission is underdeveloped domestic financial markets. The banking sector has expanded significantly over the past decade, but domestic financial markets remain shallow and constrained by structural impediments. Measured by the ratio of broad money to GDP, for example, the domestic money market is illiquid and, on average, compare unfavorably with those of other developing countries. As a result, the underdeveloped state of the domestic financial market has a bearing on not only interest rate and credit pass-through, but also all other channels of monetary policy transmission.

Financial Sector Stability

A fundamental question is whether monetary policy should lend a hand—by pursing a financial stability objective in addition to its primary mandate of price stability.

Before the global financial crisis, widespread consensus supported a strict division of labour between different policy levers. Price stability was the primary—and sometimes sole— mandate of monetary policy. Financial stability was the realm of prudential regulation and supervision. As a result, most central banks took a "benign neglect" approach to asset price and credit booms. Monetary policy was to react to movements in asset prices and credit aggregates only to the extent that they affected inflation (and output). This was reinforced by a belief that it was too difficult to distinguish fundamental-driven movements from speculative bubbles in real time. And, in any event, the policy rate was too coarse an instrument to address the associated financial risks. If monetary policy had a role, it was to respond to the macroeconomic consequences of financial instability, if and when it materialized. This debate is often summarized by the phrase “lean versus clean”.

The BoU’s approach has been ensuring stability of the entire banking system, thus the leaning against financial sector vulnerabilities associated with financial imbalances. The BoU has put emphasis to containing systemic financial sector risks by complementing traditional micro-prudential policies aimed at individual banking institutions with a macroprudential policy framework, which includes both cyclical instruments (e.g., countercyclical capital buffers and dynamic loss provisioning) and permanent measures to strengthen the structural resilience of the banking system.

It is important to note that substantial reforms have been undertaken in recognition of the crucial role of the financial sector in the development process, since the early 1990s. Nonetheless, both the Bank of Uganda and the government of Uganda acknowledge that challenges still exist, but shall continue implementing the necessary reforms to ensure that the financial sector remains resilient for it to play its role as an engine for private sector-led growth.

Today, the banking sector as a whole is adequately capitalized to withstand any shocks. As of December 2017, all commercial banks met the minimum regulatory capital adequacy requirements, with an aggregate industry-wide tier 1 capital adequacy ratio of 20.9 percent, which is well in the range of the past 10 years average of 18.7 percent while the total capital to risk weighted assets stood at 23.2 percent, well in the range of the past 10 years average of 21.1 percent. The average return on equity and return on assets declined from 30.7 percent and 3.8 percent in 2007 to 16.4 percent and 2.3 percent in 2017, respectively. Banks hold adequate liquidity buffers to withstand any liquidity constraints, with the industry wide liquid assets to total deposits ratio at 54.6 percent in 2017, with the average over the past 10 years at 45.3 percent, comfortably meeting the minimum regulatory requirement of 20.0 percent. Bank funding conditions also remain stable, with deposits contributing 83.2 percent of the total funding of the banking sector, while banks’ annual after-tax profits during 2017 were estimated at Shs. 683.1 billion, which is more than three times the 2007 realization of Shs. 188.6 billion, and almost double the past 10 years average of Shs. 399.0 billion. Although the ratio of non-performing loans to gross loans rose from 4.1 percent in 2007 to 5.6 percent in 2017, they have averaged 4.6 percent in the past 10 years.

The level of savings mobilization and financial intermediation - the extent to which banks convert the deposits that they mobilise from the general public into loans - has greatly increased. Private sector deposits as a ratio of GDP increased from 5.3 percent in 1992 to 17.0 percent in 2016. Over the same period, private sector credit as a share of GDP has risen three-fold from about 5.0 percent to 15.0 percent. The expansion of outreach has also been very impressive. In the year 2000, there were 129 branches of regulated financial institutions in Uganda. By the end of 2017, the branch network had risen to 528. The number of Automatic Teller Machines (ATMs) in the country has also more than doubled from 405 in 2008 to 854 in 2017. All these developments have led to an increase in access to financial services.

The percentage of the population aged 16 years and above accessing financial services has risen from about 30 percent in 2006 to over 85 percent – a good sign of financial inclusion. Credit is largely owed to the phenomenal growth of mobile money services, which has brought access to basic payment services within reach of millions of Ugandans who do not have ready access to bank branches or own a bank account. To improve credit risk management in the financial sector, BoU launched the Credit Reference Bureau (CRB) and the associated Financial Card System (FCS) in December 2008. Ultimately, the CRB will assist in making credit accessible to more people, and enabling lenders and businesses reduce risk and fraud associated with default. Furthermore, in order to promote fair and equitable financial practices by setting minimum standards for service providers, increase transparency and empower consumers, foster confidence in the financial services sector and provide a mechanism for handling consumer complaints, the BoU issued Financial Consumer Protection Guidelines and established a Consumer Protection Desk at the BoU in 2011. Over time, the BoU has aggressively conducted and will continue to conduct awareness campaigns to sensitise consumers of financial services on their rights and obligations. In order to broaden financial inclusion, the government has approved agent banking and is in the process of approving Islamic banking.

There are however several challenges and BoU'S focus will be on alleviating these constraints in order to further increase access to financial services. The first issue of concern is the high lending rates. In 2016, lending rates averaged 23.9 percent, and have averaged 21.3 percent in 2017, which is well within the past 10-year average of 22.2 percent. Lending rates of this magnitude are unsustainable over the long term, because most private sector firms will not generate sufficient returns to enable them to service their loan obligations. Modest reductions in lending rates in an environment of sustained monetary policy easing in part reflects a raft of supply side constraints and implies that accommodative monetary policy alone cannot guarantee affordable lending interest rates. It is desirable therefore to complement monetary policy by addressing supply side constraints, including the high cost of doing business. Nonetheless, the BoU continues to urge banks to introduce innovative cost minimising technologies in order to reduce their operating costs, which remain a key driver of high lending rates.

The degree of diversification of the financial system in Uganda also remains rather limited. Commercial banks hold about 80 percent of the total assets of the financial system. Equity markets are poorly developed, and only large and well-established firms can realistically raise finance on equity markets. As a result, most firms seeking finance for investment on the domestic market have to rely on loan finance, of which the most important source is the banking system. Government has instituted reforms to boost availability of medium to long-term finance for example, the pension sector reforms, which should expand the availability of long-term finance. In addition, the capitalization of Uganda Development Bank is also underway.

Thank you very much.