BANK OF UGANDA

UNDERSTANDING THE INFLATION TARGETING-LITE POLICY FRAMEWORK

What is Monetary Policy? Monetary policy is just one of the many economic policies pursued within an economy to achieve various economic goals, including high economic growth, financial sector stability and maintenance of price stability. With the rapid growth of the financial market in Uganda and greater integration with the rest of the world, monetary policy has assumed increasing significance in recent years. The financial system plays a critical role in transmitting monetary policy actions to spending decisions of consumers and investors, and ultimately affecting output and prices. Monetary policy involves the regulation of money stock or the short term interest rate to attain monetary policy objectives such as stabilization of output and prices. The Bank of Uganda is responsible for Monetary Policy in Uganda with its core mandate being the maintenance of *Price stability and a sound financial system*". The workings of the macro economy are such that actions of other "sectors" like fiscal policy impact on the outcomes of monetary policy. Intuitively, collaboration and coordination of policies is critical in the delivery of overall macroeconomic stability.

What is Inflation Targeting?: Inflation Targeting (IT) can be defined as a monetary policy framework with four key elements namely: price stability being explicitly recognized as the main goal of monetary policy; increased transparency and accountability mechanisms through the public announcement of targets and forecasts for inflation, and a policy of communicating to the public and the markets, the rationale for the decisions taken by the Central Bank. Another key feature is the use of a number of economic variables for making monetary policy decisions. BOU is implementing IT-lite as the preconditions for a full fledged Inflation targeting regime like well developed and integrated financial markets are pursued.

How does IT work? The main monetary policy instrument under IT is the interest rate and not money quantity. This however does not invalidate the relationship between money and prices in the long run. The implementation of IT-lite by BOU will aim at steering short-term interbank rates (7-day interbank money market rates) to be within the range of the announced Central Bank Rate (CBR). This action is premised on empirical findings that short-term interbank rates impact on longer term rates (e.g. commercial banks' lending rates), which are deemed to be fundamental for monetary policy transmission into prices and the real economy. For example, in July 2011, the BOU is varying the levels of commercial bank liquidity through repo and reverse repo auctions to influence the 7-day interbank rate to within range of the CBR of 13 percent. The CBR is set monthly at the start of the month with a corridor of 2 percentage points above and below. If the 7-day interbank rate is towards the upper bound, BOU will supply liquidity through reverse repo operations and if the 7-day interbank is towards the lower bound, BOU will withdrawal the surplus liquidity through repo operations. .

Why the shift from Monetary Targeting framework? Since 1993, Uganda implemented a Quantity based-monetary policy framework which had two key assumptions. One was that there was a stable and predictable relationship between quantity of money and prices. The other key assumption was that there was a stable and exploitable relationship between the intermediate target, broad money, and the central bank's policy instrument, which for

Uganda's case was base money. The stability and predictability of both money demand and velocity is no longer certain due to the transformation of the economy over the most recent decade. In particular, there has been rapid growth and diversification of the financial system including innovations in electronic payments systems that make the accurate targeting of money quantity, untenable.

What is the Central Bank Rate (CBR)? The CBR is a signaling rate that shall be announced within the first week of every month by the BOU. The key ingredient in setting CBR involves evaluating the future projection for core inflation. This implies making projections on several factors that affect core inflation. These include: international factors (interest rates, inflation, oil prices); exchange rates; output gap and capacity utilization; domestic demand; money supply and credit extension and expectations

Does the CBR replace the Bank rate? No, the Bank rate that existed under the previous policy framework remains, although its computation is no longer based on the 91-day Treasury bill, as a reference rate. The Bank Rate is the rate at which commercial banks can borrow from the BOU against eligible collateral. Advances to banks for up to three months are at an interest rate of one percent above the rediscount rate. The eligible collateral for borrowing from the BOU is Treasury Bills. Each bank has an automatic right to borrow from the BOU an amount up to 25 percent of its statutory reserve requirement. Any borrowing above that amount is at the discretion of the BOU.

Therefore under IT, the Bank rate is derived as the CBR plus a margin of 4 percentage points. The Rediscount rate (the rate at which the public may redeem their treasury bills and bonds before the maturity date) is equal to the CBR plus a margin of 3 percentage points. Please note that the above margins on the Bank rate and Rediscount rate are adjustable by BOU to effect a desired monetary policy stance.

What will an adjustment of the CBR mean? If BOU forecasts inflation to rise in the future, then it will increase its CBR to signal Monetary Policy tightening. This shall be aimed at forestalling the eventuality of the foreseen higher inflation through managing inflation expectations, raising the cost of borrowing and contracting money supply in the economy, and the eventual reduction in aggregate demand to bring it into equilibrium with the supply side. For July 2011, tightening of monetary policy was also meant to foster stability in the foreign exchange market by removing any arbitrage opportunities for commercial banks that would arise when left with more than optimal shilling liquidity.

In summary, the IT approach to monetary policy confers some real benefits: it embodies explicitly monetary transmission lags; it potentially embodies all information useful for predicting future inflation; and, it achieves a high degree of output smoothing.