EAGER
Policy Brief
NUMBER 50 / JANUARY 2001

Monetary and Exchange Rate Policy in Uganda

This study examines the importance of the 'fundamentals' in real exchange rate determination and assesses whether the exchange rate is affected by monetary policy and whether these effects are permanent or transitory. The study is an empirical one and first estimates the real exchange rate and investigates whether deviations from the equilibrium real exchange rate are correlated with an expansionary monetary policy or disturbances in the money market. A model where the real exchange rate is explained by terms of trade, productivity, net capital flows, government expenditure and monetary shocks is specified, estimated, simulated and forecasted as part of a system of simultaneous equations.

Questions that the study addresses include: How do you balance the inflation objective with the export sector competitiveness objective? Do monetary shocks have any effect on the real exchange rate? Is there a long run relationship between nominal money supply and the nominal exchange rate and do shifts in exchange rate regime have any effect on this relationship? Has monetary policy in Uganda been consistent with achieving international competitiveness?

The primary conclusion from the study is that the Real Exchange Rate (RER) did not significantly boost the Ugandan export sector. A case is made for regional policy harmonisation to minimize policy slippages, shocks and possible contagion. The main recommendation emerging is that a strategic and competitive export development and diversification policy and program needs to be funded and pursued vigorously and efficiently.

The Context

Uganda faces the current challenge of balancing multiple noble ultimate objectives of maintaining single-digit domestic inflation, achieving export sector competitiveness, building up gross and net international reserves, ensuring balance of payments sustainability, ensuring financial system and market stability, sustaining buoyant economic growth and eradicating poverty. This is indeed a delicate policy balancing approach that requires an additional matching array of instruments and programs as well as financing.

Strengthening of the linkages among monetary, fiscal, real and external sectors and development of a supportive road, energy and export infrastructure and an efficient financial system integrated with the informal financial sector will ensure that the economy remains on an even keel and prepare the Ugandan economy for the transition from stabilisation to cost-sensitive structural transformation, growth led by export earnings and foreign and local investment, poverty reduction and human development.

As a member of East Africa Cooperation and also COMESA (Common Market of East and Southern African States), Uganda can attest that efforts to harmonise trade policies will need to be stepped up to minimize regional policy slippages, contagion effects and other shocks to the macro economy across the vast COMESA region.

The Approach

The study seeks to discern the link between fiscal sector developments and the Real Exchange Rate. The Real Exchange Rate fundamentals that map out the Equilibrium Real Exchange Rate path (ERER) and the departures of the actual Reserve Money path from desired Reserve Money Program path determine the behaviour of the actual Real Exchange Rate path (RER). Key current account, fiscal and real variables are also modelled and estimated using linear and non-linear 2SLS and 3SLS. Policy simulations were conducted to determine the short- and long-run impact of monetary shocks and terms of trade shocks on the Real Exchange Rate path and on the major building blocks of the macroeconomy.

Government spending did not significantly appreciate RER because the Ugandan public sector has been a net saver vis-à-vis the banking system since 1992/93, thus the burden of expenditure did not fall significantly on the domestic price variable (which is a denominator in RER). Inflation has been totally subdued as a result of monetary and fiscal policy discipline. Some of the recent depreciation pressures on the RER may have reduced tax revenue because of the reduced demand for imports. Central Bank presence in the markets reduces panic and greed evidenced in widening margins. The jigsaw nature of Uganda's RER path showed that the RER did not significantly boost the Ugandan export sector.

Implications

Although there is no need for capital controls in the new era of current account and capital account liberalisation, the recent financial crises in South East Asia and Russia and contagion in Brazil point to the urgent need for developing, and strengthening the supervision of, the financial system and its legislation. For Uganda, monitoring departures of the actual Real Exchange Rate path (RER) from the Equilibrium Real Exchange Rate path (ERER) should be part and parcel of an early warning system. A key government tool is adjustment of the reserve requirements on foreign exchange liabilities, which in normal times should not be lowered or should be lowered very slowly to manage the credit creation process generated by an increase in capital inflows.

There is a need to consolidate the gains from fiscal management to enhance efficiency from the external loans and grants. External grants and concessionary external loans sought by Government should be spent on increasing the total and marginal productivity of labour and capital to boost domestic investment in road, energy, social and export infrastructure and modernisation of agriculture and industry to sustain high real growth and deal a final fatal blow to poverty. The external funds should not be 100% sterilised. Macroeconomic stabilisation is necessary but not sufficient to ensure both economic structural transformation and human development.

Export Sector Competitiveness

Uganda suffers from the lack of a strategic and competitive export development and diversification policy. Recent work by Musinguzi and Smith (1998)*, among others, suggests that maintenance of export sector competitiveness through a competitive real exchange rate policy, human development, modernisation of industry and agriculture, trade reforms and supportive infrastructure for export-led development needs to go beyond a track record of macroeconomic stabilisation to ensure economic structural transformation, poverty reduction and human development.

In Uganda's case, an appropriate policy and institutional environment must include strong macro-economic and legal frameworks, but there is a need for more open trade and commercial reforms, in addition to introduction of well-serviced and viable regional Multi-Facility Economic Zones (MFEZs).

Recommendations

- Ensure sufficient integration of the formal financial system with the informal financial sector.
- Strengthen, deepen, broaden, integrate and develop the financial system and prudential guidelines to ensure an effective, dynamic and defensive monetary policy and efficient mobilisation and intermediation of resources.
- Promote timely and adequate dissemination of monetary, fiscal and socioeconomic information to facilitate rational decision making on the part of market participants, greatly minimising panicky behaviour.
- Strengthen the institutional framework now in place for the policy interaction process, bringing together macroeconomic and sectoral stakeholders, including the formal and informal commercial sectors, to permit a conducive environment for micro-finance.

*Musinguzi, P. and Smith, P. (1998) Structural Adjustment and Poverty: A Study of Rural Uganda. Discussion Papers in Economics and Econometrics, No. 9813. Department of Economics, University of Southampton, August.

This policy brief is based on EAGER Discussion Paper Number 23, *Monetary and Exchange Rate Policy in Uganda*, 2000, by Polycarp Musinguzi [eprc@imul.com], Bank of Uganda, with Marios Obwona [eprc@imul.com], Economic Policy Research Centre, and J. Dirck Stryker, [dstryker@aird.com] AIRD, Cambridge, Massachusetts.

To Order Policy Briefs or Other EAGER Publications

EAGER Publications/BHM

P.O. Box 3415

Alexandria, Virginia 22302

tel/fax: 703-299-0650/703-299-0651

email: spriddy@eagerproject.com

All EAGER Publications can be downloaded from www.eagerproject.com