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Foresight Africa 2015: Growth and Inflation in Uganda

Uganda might be looking at good news in 2015: The country's gross domestic product (GDP) is projected to grow at 6.2 percent. Ugandans might not want to celebrate yet, though: Despite this favorable forecast, Uganda faces three major obstacles that will likely raise inflation, which in turn will cause a depreciation of the shilling as well as rising interest rates. In fact, in 2015, inflation is projected to grow to 5.4 percent from 4.5 percent. Uganda's economy will likely see bad times this year unless these major challenges are tackled head-on.

Uganda Will Likely See Inflation Rise

This prediction of rising inflation is based on several factors in the upcoming year. These include:

1. Expected **government borrowing and expenditure on non-productive activities** such as the presidential and parliamentary elections to be held the following year.

2. **Supply-side constraints.** Businesses are cutting back the supply of essential commodities such as food, sugar, salts and petroleum products—this reduction in supply of essential

commodities is mainly due to the uncertainty presented by elections. This cut-back is likely to push the prices of most manufactured goods up because they use those commodities as intermediate inputs.

3. **Depletion of Uganda's foreign currency reserve.** Typically, Uganda keeps a foreign currency reserve worth four months of imports: $3 billion. Market trends suggest that persistent speculation expected in 2015 may significantly reduce the size of the reserve, reducing the central bank's capacity to manage inflation.

The speculation on Uganda's financial market in 2015 may take two directions: The first is through a rapid accumulation of foreign-denominated savings by private citizens in commercial banks. Indeed, liberal estimates indicate an unprecedented rise of foreign currency-denominated deposits, to the tune of 35 percent of total saving in 2014, which is consistent with a depletion of foreign currency reserves. The second is through capital flight, as foreign investors hedge their bets and temporarily suspend operations in Uganda due to uncertainty presented by electoral outcomes. In fact, electoral cycles often coincide with an exit of foreign investors and a significant conversion of domestic wealth into foreign assets.

Inflation and the Continued Depreciation of the Ugandan Shilling

In 2014, the effects of inflation were apparent in the rapid (12 percent) depreciation of the Ugandan shilling against the dollar, which prompted some speculation in the market as traders demanded and hoarded dollars in expectation of further depreciation. The shilling is expected to dip even further in 2015, possibly to 2011 levels.

There are several potential reasons for the depreciation of the shilling: It could be related to gains made by the dollar in the global market owing largely to the rise in U.S. employment. In fact, other international currencies have also depreciated: the Kenyan shilling weakened in January 2015 to lows last seen in late 2011. The depreciation of the Uganda shilling could also be linked to reduced remittances from Ugandans working abroad and the rapid fall in commodity prices.

The depreciation will not be good news. Since Uganda's exports are mainly primary raw materials, and primary goods do not command a high price in the international market, there is not much room for the agricultural and industrial sectors to exploit the easing of the exchange rate. In addition, the civil strife in South Sudan—Uganda's leading export destination—will continue to affect 20 percent of

Uganda's exports. Therefore, imports are likely to continue to exceed exports in 2015.These factors will hurt Uganda's efforts to sustain real growth and create jobs.

Inflation and Rising Interest Rates

Furthermore, a report by the Standard Chartered Bank suggests that inflation is likely to push the Ugandan central bank's lending rate to 13 percent at the end of 2015 from 11 percent in 2014. The projected interest rate increase is explained by an expected surge in government borrowing and spending in 2015. Government net domestic borrowing has increased from 441.7 billion shillings in July 2014, to 1,819.3 billion shillings in September 2014. Such actions may constrain the money flow to the private sector in 2015. This trend is also bad news: A high interest rate in 2015 may diminish bank customers' ability to repay loans. Also, the scarcity of credit may reduce the productivity of the private sector, hurt the survival of small business, negate the growth of GDP and injure the competitiveness of Uganda on the global stage. As such, many industry players are cautious of the continued use of treasury bills for government borrowing to fund non-priority sectors.

What Should Uganda Do in 2015?

In 2015, inflation will erode incomes to a degree, widen the income gap, increase the cost of infrastructure projects and service delivery (especially in the health and education sector), reverse the gains made in poverty reduction, and curtail the achievements made in the mitigation of disease and drought. Therefore, containing inflation should be a key objective of the Bank of Uganda in 2015.

In fairness, the Bank of Uganda, by raising interest rates, has so far reacted successfully to developments that threaten to raise 2015 inflation above its target of 5 percent. More immediately, the Bank of Uganda has indicated that it will fund any rising government domestic borrowing requirement by issuing government securities to the market, and not by central bank financing. In this case, there will be no monetary financing of fiscal deficits. However, a study by the Economic Policy Research Centre disagrees with this policy, by arguing that domestic borrowing by government crowds out private sector investment. In our view, whereas controlling inflation is important, the Bank of Uganda should also exploit modalities of using monetary policy instruments, such as interest rates, to stimulate private investments, exports and private sector competitiveness in 2015.

Note: *Corti Paul Lakuma and Musa Mayanja Lwanga are research analysts in the macroeconomics department of the Economic Policy Research Centre (EPRC) at Makerere University in Kampala, Uganda. EPRC is one of the Brookings Africa Growth Initiative's local think tank partners based in*

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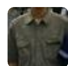

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