Article

Uganda's central bank cut its benchmark interest rate for a second time this year to a new low as risks to inflation remain benign and the outlook for economic growth is tilted toward the downside.

The monetary policy committee reduced the rate to 7% from 8%, Governor Emmanuel Tumusiime-Mutebile said Monday in a speech broadcast online. That is the lowest level since the central bank introduced the policy rate in 2011 at 13%.

Returning to pre-pandemic levels of economic activity will be gradual, partly due to weak external demand, Tumusiime-Mutebile said. The central bank now sees the economy expanding 2.5% to 3.5% this year, compared with its April forecast of 3% to 4% growth. While the risks to the outlook are "extreme and tilted toward lower economic growth" expansion will pick up to 4% to 5% next year and 6% to 6.5% in 2022, he said.

"The forthcoming fiscal stimulus together with accommodative monetary policy might offset the negative impact the Covid-19 pandemic has on the economy in a manner that is stronger than currently envisaged," he said.

Inflation slowed to 2.8% in May from 3.2% in the previous month. External sources of price growth, food crop inflation and risks from shilling depreciation are all expected to remain weak, according to the MPC. The rate of price growth will therefor remain below the medium-term target of 5% in the next 12 months, the panel said.

The central bank in April asked banks to restructure struggling debt for a maximum of 12 months to give borrowers hit by the coronavirus pandemic some breathing space. The East African nation has received $491.5 million in International Monetary Fund financing, half of which it has earmarked for manufacturers.

Analysis

Due to the COVID-19 pandemic, Uganda's central bank is implementing expansionary monetary policy, reducing the rate from 8% to 7% in order to stimulate the economy. Interest rates are a constant rise in price level over time. Expansionary monetary policy is a demand-side policy to increase the AD of an economy by changing money supply to affect interest rates. AD is the total quantity of goods and services demanded in an economy over a time period at a certain price level, *ceteris paribus.*

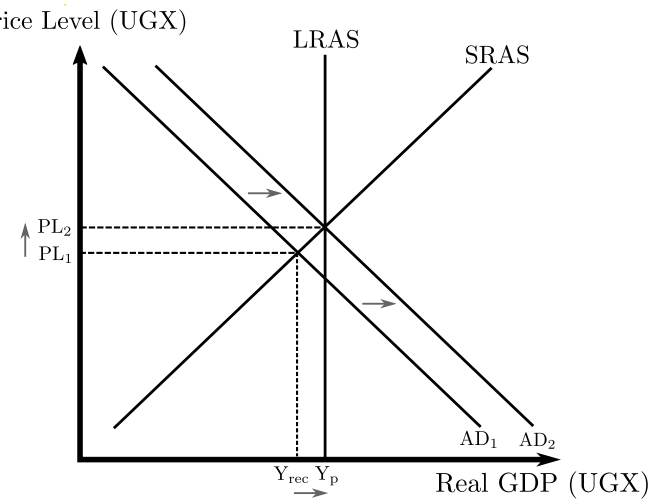

Figure 1: The effect of expansionary monetary policy on the Ugandan economy.

As economic growth in Uganda is "tilted toward the downside", the economy is assumed to be at a recessionary gap. Expansionary monetary policy is used to increase AD by lowering interest rates, reducing the cost of borrowing money and saving rates, which increases spending and decreases savings.

Figure 1 illustrates the effect of expansionary monetary policy on the Ugandan economy from a neoclassical perspective. The Long Run Aggregate Supply (LRAS) curve is perfectly inelastic in neoclassical views, meaning that output in the economy is independent of price level in the long run. Prior to the decrease in interest rates, the economy was operating at a recessionary gap at AD_1 as it operates below potential output Y_p. The increase in AD due to the policy is illustrated by an outward shift of the AD curve from AD_1 to AD_2, causing the new AD curve to intersect with LRAS and SRAS, reducing the recessionary gap from Y_{rec} to Y_p. This causes a rise in price levels from PL_1 to PL_2.

A central bank is usually independent of the government, meaning that it can be easily changed for the long term benefit of the economy without going through political hurdles. Additionally, because of this, the interest rates can be gradually changed, allowing for more control over AD compared to other policies. Furthermore, monetary policy changes are easily reversible and usually have little to no effect on the government budget, allowing for greater flexibility compared to other policies.

However, monetary policy can also affect exchange rates, which may interfere with other government objectives. For example, with lower interest rates, fewer overseas investors would want to save in Ugandan Shillings (UGX), therefore reducing demand and lowering the price of UGX, causing more expensive imports and cheaper exports, improving net exports and real GDP in the economy. Therefore, while monetary policy may improve the domestic economy, it may also conflict with the pursuit of foreign economy objectives.

In evaluation, it is difficult to know how AD will increase due to the new policy, as spending habits of both individuals and firms are difficult to predict. For example, loans are typically for investment and not consumable goods, so if the market is more suited for consumer goods rather than investment, the policy would not be as effective.

Additionally, a 1% decrease in interest rates is relatively small, so individuals and firms may react slowly to the change, creating a time lag between the implementation of the policy and changes in AD. However, by that time, the economy could have changed, and a different policy may be needed instead.

Furthermore, monetary policy is possibly less effective during a severe recession. This is because banks may not be willing to increase their lending due to fears of borrowers not being able to repay the loans. As a result, consumers and firms may avoid taking out loans, which would possibly reduce investment and consumer spending, not affecting real GDP, or even decreasing it.

As a result of the reasons above, the Ugandan government also plans to implement "fiscal stimulus" alongside monetary policy in order to further "offset the negative impact the COVID-19 pandemic has had." As the rate of inflation was not high due to inflation slowing to "2.8% in May", so the use of expansionary fiscal policy could be implemented without much risk of rising inflation rates due to the extra policy. Moreover, the Ugandan government could also implement supply-side policies by investing in technology, education or healthcare, which would cause the LRAS curve to shift outwards to create a new potential output Y_p. However, this policy will take even more time to impact society, which may not be suitable in order to drive AD in the short term.

Ultimately, monetary policy is still a good measure as it allows for minute adjustments to AD, however, due to the drawbacks of monetary policy, the Ugandan government should also use fiscal policy wisely to stimulate the economy.

Word Count: 748