AFRICA PREBRIEF

The Bank of Uganda Attempts The Impossible

Uganda's central bank, the **Bank of Uganda**, is giving a case study in the difficulty factors involved in managing the monetary unit of a country whose economy lacks the necessary attributes - in terms of size and scale - to qualify as an optimal currency area. In this era where hardly a single nation-state is economically sovereign with currencies unable to withstand a speculative attack, Uganda's monetary policy decision-making has consequences not only for itself but an entire East African region interconnected on a political, cultural and economic level.

To say that **Central Bank Governor Emmanuel Tumusiime-Mutebile**'s dramatic response to speculators last month (http://www.bou.or.ug/bou/media/videos/Governor_Warns_Speculators.html) is 'bold' is an understatement. That it is an understandable rhetorical and policy response to a serious problem, but one which is setting the shilling up for a virtual free fall is our greater concern.

In an effort to halt the fall of the Ugandan shilling – just off of levels not seen in 18 years – the central bank has sold over $60 million (Shs160 billion), into the open market since June 15, 2011 (when the exchange rate came under speculative pressure resulting in outflows of about US $30 million). An additional undisclosed amount of dollars, described as 'significant,' and 'sizable,' was sold yesterday.

Prof. Emmanual Mutebile's insistence that he and the BOU were ready and able to ward off speculative attacks punctuated by his statement, "I am not indifferent to further exchange rate depreciation," is credible in the short term when one considers that the central bank has $2 billion in reserve dollar holdings. But it is not a claim that we believe can continue to be made if things continue at the current trajectory, when one considers that Uganda has a widening trade deficit of virtually that exact amount - $2.1 billion - built upon an economy that exports coffee, tea, flowers and fish while it imports fuel, machinery, clothing, steel, and vehicles (http://www.monitor.co.ug/Business/-/688322/1193836/-/3wgj99/-/index.html).

The estimated amount of current reserves is sufficient to cover no more than 4 months of imports – an uncomfortable socio-economic buffer considering the instability and dissatisfaction in the country since April – including riots (http://www.nation.co.ke/News/africa/Two+killed+as+food+riots+rock+Kampala+/-

/1066/1153412/-/k1lhiwz/-/index.html and http://www.monitor.co.ug/News/National/-/688334/1153024/-/c25eudz/-/index.html) as a result of rising food and fuel prices and political tensions.

With these realities the Bank of Uganda is up against the clock – racing to stem inflation while it anxiously awaits next year's changing circumstance which finds Uganda an oil *producer* as a result of its exciting Lake Albert Basin find exploited into production by the UK's **Tullow Oil PLC** (see our **June 14, 2011*APB* "Tullow's IPO In Ghana And The Rise of Secondary Listings In Africa").**

The greatest immediate threat to the Ugandan shilling – which stood at 2530.8918 to $1 dollar on July 4th – may be the decision to switch to inflation targeting, one of the least workable monetary regimes (http://www.monitor.co.ug/Business/Business+Power/-/688616/1189724/-/o1d45nz/-/index.html and http://af.reuters.com/article/investingNews/idAFJOE7630DK20110704).

That the new approach has been selected to replace the absolutely outdated monetarist regime (discredited in the United States in the 1980s) which targeted the money supply, is hardly a source of comfort, though the switch is being hailed as a move that will enable to the Bank to get a better handle on inflation.

Unfortunately this is impossible.

Why?

Because not only is the BOU moving to an inherently flawed monetary regime, it is attempting to simultaneously target ***both*** monetary policy (http://www.bou.or.ug/bou/monetary_policy/framework.html) and an exchange rate (whether publicly revealed or not, this is clearly implied by **Governor Emmanuel Tumusiime-Mutebile**'s words) as it aims at placing a floor on the value of the shilling - by mopping up shilling liquidity with dollars and raising interest rates - while encouraging its banks to lend more.

This cannot be done without speculators spotting and exploiting the obvious contradictions.

What the Bank of Uganda's decisions are manifesting is the lack of a clear taxonomy on exchange rate regimes and why its latest move will have serious unintended consequences.

As we explained in our **June 22 *APB*, "Kenyan Shilling Enters Danger Zone But…"**

"There are three types of exchange rate regimes: floating, fixed and pegged rates. Each has different characteristics generating different results. Although floating and fixed rates appear to be dissimilar, they're members of the same family. With a floating rate…a monetary authority sets a monetary policy, but has no exchange-rate policy – the exchange rate is on autopilot. In consequence, the monetary base only contains a domestic component, determined by a monetary authority. Whereas, with a fixed rate, a monetary authority sets the exchange rate, but has no monetary policy – monetary policy is on autopilot. In consequence, under a fixed-rate regime, the monetary base only contains a

foreign component, determined by the balance of payments. In other words, when a country's official net foreign reserves increase, its monetary base increases and vice versa. With both of these exchange-rate mechanisms, there cannot be conflicts between exchange-rate and monetary policies, and consequently, balance of payments crises cannot occur. Indeed, under floating and fixed-rate regimes, market forces act to automatically rebalance financial flows and avert balance of payment crises.

Fixed and pegged rates appear similar but are fundamentally different. Pegged rates require a monetary authority to manage *both* the exchange rate and monetary policy. Unlike floating and fixed rates, pegged rates result in conflicts between exchange rate and monetary policies. For example, when capital inflows become 'excessive' under a pegged system, a monetary authority often attempts to sterilize the ensuing increase in the foreign component of the monetary base by reducing the domestic component of the monetary base. As outflows become 'excessive,' an authority attempts to offset the decrease in the foreign component of the base with an increase in the domestic component of the monetary base. Balance of payments crises erupt as a monetary authority begins to offset more and more of the reduction in the foreign component of the monetary base with domestically created base money. When this occurs, it's only a matter of time before currency speculators spot the contradictions between exchange rate and monetary policies and force a devaluation."

What Uganda is trying to pull off is a managed float where it will periodically intervene in open markets to keep the shilling at a certain level. But in reality, by indicating it has a floor – an exchange rate level beneath which it will not allow the currency to fall – while still managing a domestic monetary policy, it is only masquerading as a fixed exchange rate regime when it is really only operating an unsustainable semi-pegged exchange regime.

Were Uganda to outright state it will defend the shilling-dollar exchange rate and maintain it at say a level of 2000 UGX to 1 USD but allow its monetary policy to go on auto pilot it would have an authentic fixed exchange rate. This would only be sustainable and strong enough to ward off speculative attack if all of the **East African Community** or **EAC;** and the **Southern African Development Community** or **SADC** executed a coordinated currency action *with the explicit goal* of moving toward a single monetary union and regional currency for Eastern and Southern Africa *at a time certain*. The combination of these two regions would approach the size and scale to qualify as an optimal currency area.

With nothing realistically on the horizon along these lines, Uganda, despite its $2 billion in reserves, is heading in the direction of further and we believe dramatic currency weakness.

That Uganda is now grabbing the same monetary policy that South Africa utilized in 2001 – inflation targeting – is a comfort to some but hardly analogous in significant areas. Such optimists seem to lack a clear understanding of the shortcomings of this much celebrated monetary regime. As we explained in our ***APB*** **March 10, 2011, "The Rand And The Pan-African Portfolio**:"

"The SARB's management of liquidity relative to consumer price indices and exchange rates is a mess as it utilizes five open market instruments and transactions which all represent shifting targets of their own: 1) the creation of a liquidity requirement (or shortage) which it refinances at the repurchase rate 2) cash reserve requirements (the balance it requires banks to hold on its accounts with the central bank). And to drain liquidity the SARB utilizes 3) debentures, 4) longer term reverse repos and 5) foreign exchange swap transactions [i.e. swapping dollars for rand].

Despite the sophisticated techniques employed, they often produce forecasts that are disconnected from reality which can then lead to questionable policy responses; indeed, the earliest classic example was in the fourth quarter of 2001, when the South African Reserve Bank (SARB) increased the supply of high-powered base money by 18% in the face of falling domestic and international demand for the rand.

Such a system sets up a system of alternating winner and losers."

What South Africa has struggled to find – currency stability free of a contentious debate between exporters and importers – will be even more elusive for Uganda whose money markets are more shallow and lack as sophisticated an array of monetary policy instruments juxtaposed to an economy which desperately needs to diversify beyond the export of commodities (Agriculture is the most important sector of the economy, employing over 80% of the work force. Coffee accounts for the bulk of export revenues: https://www.cia.gov/library/publications/the-world-factbook/geos/ug.html).

Furthermore, the BOU is enduring a human capital flight of sorts with a wave of retirements reportedly "including two Executive Directors, two Directors, four Deputy Directors, six Assistant Directors and staff of various ranks…" (http://www.monitor.co.ug/Business/-/688322/1195144/-/3whrf8/-/index.html) that is sure to impact efficiency and execution in its efforts.

Our greatest concern with Uganda has always been its demographic ticking bomb – with 50% of its population at 14 years of age or under, with rising exposure to Western novelties (and desire for them) and endemic unemployment. Our second greatest concern has been the effort by many within **United States** political circles who have long sought to depict Uganda as a bastion for terrorism, even suggesting or implying that military action should be taken to thwart a rising threat. This demonization is typified by the work of **Senator Richard Luger** and his ominous "**Nunn-Lugar Global Africa Mission," (http://lugar.senate.gov/nunnlugar/africa/)** which depicts the country as a throne of bio-terror threats like anthrax, as well as a haven for al-Qaeda**.**

With the Bank of Uganda's decision to deploy a weapon in its fight against inflation that can only backfire, we worry that the Ugandan economy will become collateral damage, with negative impact felt throughout Africa's most promising region.

Despite good intentions, the Ugandan shilling is now potentially a weapon of mass destruction.

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July 5, 2011

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