BANK OF UGANDA

Presentation by

Dr. Adam Mugume,
Director Research- Bank of Uganda

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Inflation Targeting as a Framework for Maintaining Price Stability.

1. Introduction.

What sort of monetary framework is appropriate for Uganda as it seeks to establish itself as a full-fledged emerging market economy in the 21st century?

- Monetary policy involves regulation of money stock or the short term interest rate to attain monetary policy objectives such as stabilization of output and prices. The responsibility for the conduct of monetary policy generally rests with the central bank of the country, as it enjoys considerable control on regulation of money stock through its monopoly over issue of currency, and creation/ destruction of bank reserves.
- Monetary policy is an important constituent of overall economic policy towards the pursuit of various economic goals, including higher economic growth, and maintenance of price stability.
- Over the past century, the prominence of monetary policy has been on a steady rise, and presently, hardly a day goes by without some mention of monetary policy appearing in the headlines. Economists and market analysts are making considerable efforts towards continuous speculation about the likely future actions of the monetary authorities across the matured and the emerging economies.
- With the 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.

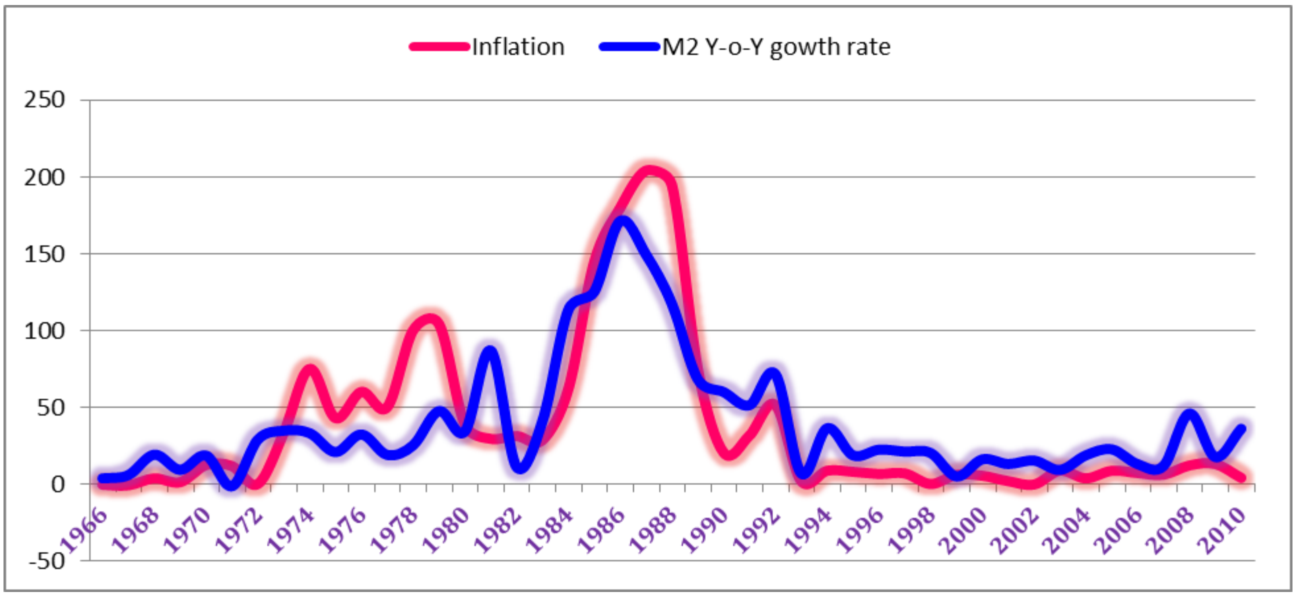
- As recently as the early 1990s, the prevailing orthodoxy in Uganda and across much of Africa was that monetary policy could and should be deployed as a purposive instrument in the broader development process.
- Post-Independence monetary frameworks in Uganda and in Africa as a whole was largely geared towards the (cheap) financing of government activities, the extension of subsidized credit to favoured sectors and an active pursuit of an exchange rate target (more often reflecting the interests of powerful urban consumers at the expense of producers), rather than to the control of inflation.
- Moreover, weak fiscal control – informed to a degree by the same orthodoxy – meant that monetary policy was conducted in an environment of substantial fiscal dominance, so that even basic macroeconomic policy coherence was achieved only by recourse to progressively tighter controls on the capital account and other policies that repressed the development of domestic financial markets.

- This cocktail of fiscal dominance and the overburdening of monetary policy with multiple objectives led to the inevitable outcome that Uganda's monetary regime neither delivered low inflation nor did it post sustained gains on the other policy objectives.

  - The Inflation and M2 annual growth rates in the chart shows a stern relationship between the two in the period to 1992.

- By the early 1990s, however, the evident failure of an (over) activist monetary policy encouraged moves to dismantle control regimes, liberalize foreign exchange markets and establish more robust fiscal regimes (in the context of IMF-supported stabilization programmes).

- As a consequence, BOU today is not on pressure to accommodate domestic fiscal deficits, systems of financial repression were dismantled, and flexible exchange rates has opened up the space for genuinely independent central bank to function.



- The transformation of the macroeconomic landscape in Uganda, as elsewhere in Africa, has so altered conditions that the redesign of the monetary framework is both pressing and meaningful.

- This transformation is not just in terms of economic conditions but also of perceptions of the scope and limits of monetary policy.

2. Monetary targeting:

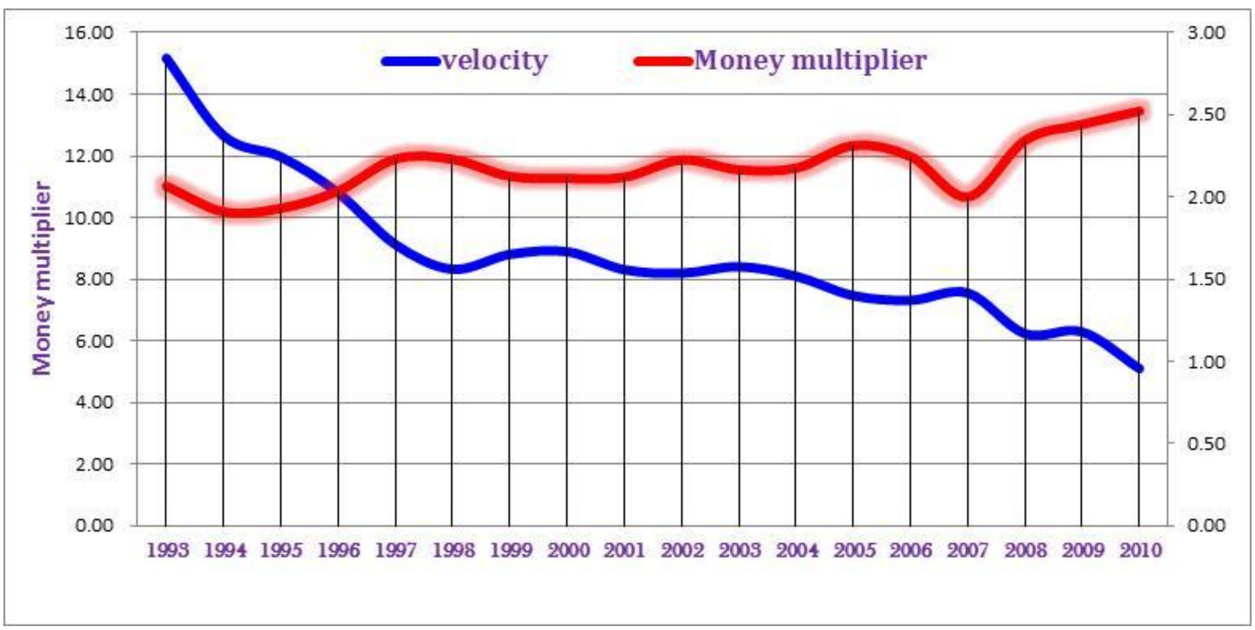
- Virtually all contemporary monetary regimes can be thought of as inflation targeting in the strict sense that a central objective of monetary policy is to establish a credible anchor for domestic prices.
- Frameworks differ in terms of how they operationalise this objective, in other words how they choose the nominal anchor.
- The nominal anchor is some quantity or price in the economy targeted by the monetary authorities. The anchor determines the path for average prices around which all relative prices are determined and in the long-run the growth rate of nominal aggregates (nominal income, nominal interest rates) will converge to the growth rate of the anchor (plus any real growth in the underlying real variables).
- This choice is not un-constrained, however; rather it has implications for how the authorities address the other concerns competing for their attention.
- This tension is encapsulated in the notion of the impossible trinity or trilemma which states that beyond the short-run no country can simultaneously maintain an open capital account, target the exchange rate and pursue an independent monetary policy.
- One of the three must be abandoned even though each is desirable in its own right: open capital accounts to the extent they support the efficient global allocation capital to high-return investment opportunities; exchange rate targeting to support trade and sustain a stable external value of the currency; and an independent monetary policy to pursue domestic output stabilization objectives.
- If for example the economy is subject to positive external shock which raises the return to domestic assets (this may be a exogenous fall in the country risk premium or some technology shock that improves prospects in the domestic economy). With an open capital account, foreign private capital will flow in, thereby generating an incipient appreciation of the currency.
- Attempts to stabilize the exchange rate will draw the central bank into foreign exchange intervention, thereby undermining the autonomy of domestic monetary policy through the effect of intervention on the domestic money stock.
- Restoring monetary autonomy through bond sterilization may work but only by driving up domestic interest rates relative to world rates, thereby exacerbating the original pressure on the exchange rate. Eventually one of the objectives must be abandoned.

The rationale for money targeting as an anchoring mechanism builds on two assumptions, both of which are verifiable.

The first is that the manner in which the private sector manages its wealth portfolio, of which the demand for money is one crucial element, induces a predictable relationship between money and prices. If this relationship is stable, then a policy that targets the growth of nominal money in has some prospect of stabilizing inflation at desired levels and at reasonable cost in terms of other objectives.

The second assumption is that there is a stable and exploitable relationship between the intermediate target, money, and the central bank's policy instrument, which in the case of Uganda and most other African economies, is currently base (or reserve) money.

- The Bank has increasingly recognised that, with liberalised financial markets, monetary policy could affect inflation primarily through its ability to influence interest and exchange rates, and the impact those prices, in turn, had on spending and pricing behaviour throughout the economy.
- It has become increasingly evident that the hoped-for relationships between the base money and broader monetary aggregates and between the monetary aggregates and monetary policy goals have weakened over time as shown in the chart below.



- It has become apparent that, over time horizons that mattered importantly for monetary policy, different monetary aggregates exhibit widely disparate growth rates. Hence it is important to know which specific measure of money presented the appropriate benchmark to which to respond, something that the existing empirical literature has not settled.

- More fundamentally, changes in conditions affecting the public's holding of deposits—the introduction of new electronic technologies that made possible for new ways for both households and firms to manage their money holdings, banking, and the increasing globalization of the world's financial system, which has enabled large deposit holders to substitute more easily across national boundaries in the deposits and alternative instruments they held in their portfolios—destabilizing what had at least appeared to be long-standing regularities in the demand for money.
- In parallel, the empirical relationships linking money growth to the increase of either prices or income, which has been the core empirical underpinning of the insight that limiting money growth would slow price inflation in the first place, has begun to unravel.
- Standard statistical exercises that for years had shown a reasonably stable relationship of money growth to either inflation or nominal income growth (specifically, stable enough to be reliable for policy purposes) no longer do so.
- Partly because stable relationships never developed between the narrow banking system quantities (base money) and relevant measures of spending or economic activity, the interest and exchange rates have proved to be very volatile.
- Most central banks have either downgraded or abandoned altogether their targets for money growth, and turned to setting interest rates as a way of making monetary policy without any specific intermediate target. With the memory of the inflation of the 1970s and early 1980s still freshly in mind, however, policymakers in many countries are also acutely aware of the resulting lack of any "nominal anchor" for the economy's price level.
- In response, an increasing number of central banks adopted various forms of "inflation targeting," under which the central bank both formulated monetary policy internally and communicated its intentions to the public in terms of the relationship between the actual inflation rate and some designated numerical target.

3. What is inflation targeting?

IT can be defined as a monetary policy operating strategy with four elements:

- an institutionalized commitment to price stability as the primary goal of monetary policy;

- mechanisms rendering the central bank accountable for attaining its monetary policy goals;
- the public announcement of targets for inflation; and
- a policy of communicating to the public and the markets the rationale for the decisions taken by the central bank.

  Other features involve the use of a number of economic variables for making policy decisions, and a general commitment that price stability is the ultimate target of monetary policy.

- So clearly an inflation targeting arrangement is not just about public pronouncement of an inflation target/range. Important features of an inflation target arrangement include the definition of what type of inflation is being targeting, the inflation target range, the use of exclusion clauses or caveats (i.e. under what circumstances the central bank is able to overshoot its target), and the target horizon. All of this information needs to be publicly available and fully transparent.

- The most distinctive and most important achievement of the inflation-targeting central banks has not been the reorientation of the goals of monetary policy toward a stronger emphasis on controlling inflation but rather the development of an approach to the conduct of policy that focuses on a clearly defined target, that assigns an important role to quantitative projections of the economy's future evolution in policy decisions, and that is committed to a high degree of transparency as to the goals of policy, the decisions that are made, and the principles that guide those decisions.

- One important advantage of commitment to an appropriately chosen policy rule is that it facilitates public understanding of policy. It is important for the public to understand the central bank's actions, to the greatest extent possible, not only for reasons of democratic legitimacy—though this is an excellent reason itself, given that central bankers are granted substantial autonomy in the execution of their task — but also in order for monetary policy to be most effective. For not only do expectations about policy matter, but, at least under current conditions, very little else matters.

- Some features of inflation targeting have become common to other monetary frameworks. In particular, transparency and communication, the hallmarks of the inflation-targeting framework, are no longer unique to it. Similarly, while all inflation-targeting central banks are explicitly forward-looking in formulating monetary policy with reliance placed on inflation forecasts, this has become more widespread.

- Inflation targeting need not imply that policymakers take the economy's inflation rate to be the sole objective of monetary policy. But whether inflation is the central bank's sole target or not, for purposes of the implementation of monetary policy what matters is that the economy's inflation rate stands at far remove from anything that the central bank can plausible control in any direct way. Under inflation targeting no less than other policymaking rubrics, the central bank has to implement monetary policy by setting the value of some instrument over which it actually exerts direct control. For most central banks, including those that are "inflation targeters," that has meant setting a short-term interest rate.

  - There is no unique way of implementing inflation targeting and application varies across countries. For example, there are differences in the nature of communication and degree of transparency. Recent developments in transparency involve the provision of the central bank's projection of the interest rate which is used in their forecasting models; others use market forecasts or assume an unchanged interest rate path.

  - Operationally, there are also differences in the levels and specifications of the targets. While most countries specify a point target, usually with a tolerance level around it, some specify a band. Some require inflation to be within the target at all times (e.g. the UK and South Africa), while others require *expected* inflation to remain within the target over the medium term (e.g. Australia and New Zealand). Differences also emerge when specifying a policy time horizon and the length of the horizon. Some targeters have an explicit escape clause, explanation clause or caveat that provides for deviations from the target under certain circumstances, usually in the event of supply-side shocks.

  - Some countries do not regard themselves as official targeters, yet bear many of the characteristics (e.g. Switzerland and the euro area). The distinction between inflation targeters and non-targeters has become so blurred at times that Mervyn King, Governor of the Bank of England, has argued that "any coherent policy reaction found can be described as inflation targeting".

  - Most monetary policies try to achieve a low-inflation environment. By making the target explicit, inflation targeting helps to manage or anchor inflation expectations. Inflation expectations do not automatically become anchored as a result of the announcement of the target; credibility has to be built up through successful application of monetary policy. Once achieved, well-anchored inflation expectations help to reduce the cost of reacting to deviations from the target.

The flexibility of inflation targeting

- Inflation targeting lite regimes typically share some common features: (1) multiple monetary policy objectives; (2) mixed operating targets and instruments including short-term interest rates, exchange rate, reserve money or aggregate money; (3) exchange rate intervention; (4) opaque monetary policy formulation (depending on the weights given to each objective and the transmission channels); (5) the constrained transparency of monetary policy operations; and (6) emphasis on financial stability. In line with Stone's definition,

- The time-inconsistency theory of optimal monetary policy showed that if too much discretion were allowed in the conduct of monetary policy, there would be an inflationary bias in the economy.

- The fact that monetary authorities know that they could achieve real output effects by surprising the market means that market participants would anticipate this possibility, and wages and prices would be set accordingly. To overcome this, proposed mitigation is an independent and conservative central banker who would put a greater weight on inflation than does society. Economic agents would factor this into their wage and price settings. Inflation would remain under control, but the consequence would be higher output variability.

- Has inflation targeting, in fact, produced the conservative central banker or what Mervyn King coined the 'inflation nutter' who eschews other economic objectives? There are divergent views. For example, Stiglitz (2008) argue that inflation targeting unnecessarily constrains growth because of its narrow focus and lack of discretion, while others argue that because it allows too much discretion, it cannot be expected to anchor expectations.

- Inflation targeting can be seen as a compromise of the 'rules-versus-discretion' debate: Bernanke et al. (1999), for example, characterise inflation targeting as a framework of "constrained discretion".

- Some argue that this is both its weakness and its strength. Unlike the pure rules-based case which allows for no flexibility, inflation targeting defines a broad rule, but allows for some discretion which is constrained by the basic rule.

  - It has also been suggested that an inflation-targeting framework may give too much discretion in countries with weak institutional environments and this would lead to unfavourable macroeconomic outcomes.

- In order for inflation targeting to constrain discretion, it has to be supported by the public and the political process.
- However, rigid rules, such as a fixed exchange rate target or some form of strict monetary rule, have the drawback that they lack flexibility in the face of shocks and may induce unsustainable conditions, often manifested in some form of crisis.
- Such rules place the burden of adjustment on output, when faced with a shock. The extreme or 'strict' version of inflation targeting would suffer from the same drawback.

- Emerging markets are more susceptible to shocks than advanced economies and they therefore require greater flexibility in responding to these shocks. The critical questions are: does the IT framework allow for too much or too little discretion and is the focus on inflation to the exclusion of other objectives?
- Inflation targeting emerging-market economies have performed less well than developed economies. However, this could be ascribed to the fact that inflation targeting is more challenging in emerging markets rather than to a lack of commitment to the targets.
- Should a more challenging environment discourage the adoption of inflation targeting or is this an appropriate framework for dealing with such vulnerabilities and challenges? It is important to distinguish between preconditions, which may be more difficult and more costly for emerging market economies to put in place, and their greater vulnerability to exogenous shocks.

- Various preconditions or requirements are seen as essential for the successful implementation of inflation targeting, and relate to rectifying institutional weaknesses, lack of credibility and lack of technical capabilities. It is also necessary to have a relatively well-developed financial system to facilitate the effective transmission of monetary policy.
- However, it is not necessary for all the requirements to be met fully before the implementation of inflation targeting.
- The feasibility and success of inflation targeting depend more on the authorities' commitment, and ability to plan and drive institutional change after the introduction of the new framework. In fact, the introduction of inflation targeting

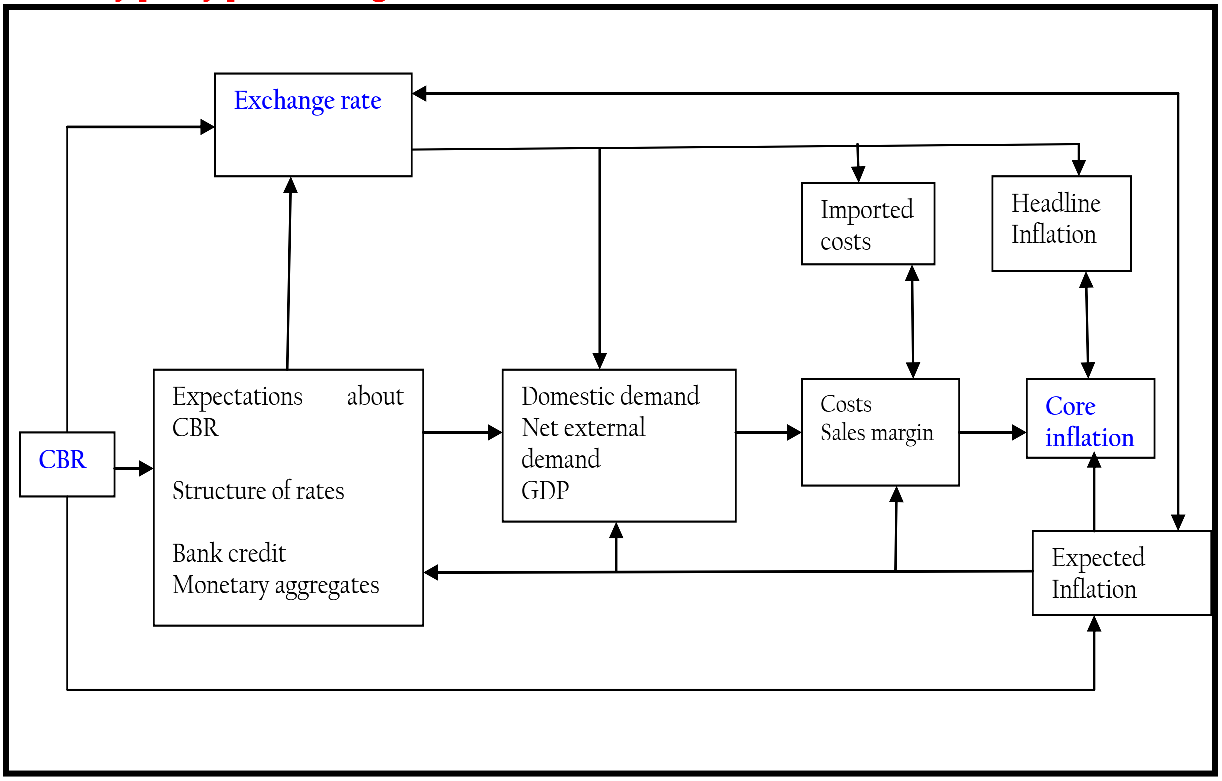
has, in a number of emerging markets, led to a rapid improvement of institutional structures and technical capabilities.

4. How the process will work.

- Under inflation targeting, the main monetary policy instrument is the interest rate and not money per se. This does not invalidate the relationship between money and prices in the long run.
- The implementation of monetary policy will aim at steering short-term interbank rates. Short-term interbank rates impact on longer term rates which are deemed to be fundamental for monetary policy transmission into prices and real economy.
- The steering of interbank rate to be in the range of CBR will involve the central bank's varying the supply of bank reserves, or some other subset of its own liabilities, in the context of an interest-elastic demand for those liabilities on the part of the private banking system and perhaps other holders as well (including the nonbank public if the measure of central bank liabilities taken to be relevant includes currency in circulation).

- The key ingredient in monetary policy decision-making involves evaluating the future projection for inflation.
- Aside from assumptions about the structure of the economy, building these projections requires incorporating future monetary policy decisions.
- The usual working assumption is a Central Bank Rate that is associated with the gap between projected and target inflation, the output gap, exchange rate variability.
- This does not attempt to literally reflect how the Central Bank sets the monetary policy rate, but rather to serve as an analytical premise used to project inflation and growth and ensure they are consistent with money's neutrality in the long run.

Monetary policy pass-through mechanism.



- Establish a BOU policy rate based on an average 7-day tenor interbank rate.
- Establish a corridor for short-term interbank market rates by allowing banks to have access to an unconditional deposit and lending facility at the BOU. It is not a science setting this corridor and we propose 7-day tenor interbank rate plus/minus 2 %.
- Conduct fine-tuning operations so that amount of liquidity ultimately makes it possible for market rates to converge toward the **BOU** policy rate.
- Use purchases/sales of government securities on the secondary market for structural liquidity management. This will require separation of instruments for monetary and fiscal policies.
- The monetary policy meeting will be the main instance where monetary policy decisions are made.
- Every meeting will review events since the previous session, their implications for inflation projections over a period of around one quarter, and policy alternatives. The meetings will also review projections for exchange rate and growth, among other variables.

There are two main reasons to why the monetary policy rate will be changed at any given time:

- When inflation projections are not consistent with the target. The monetary policy rate will be changed when inflation projections persistently move away from the target. This may occur, for example, when new information builds up on the economy's progress, which changes the likely inflation rate. Between two monetary policy meetings, information can signal changes in projections for exogenous variables (for example, the expected oil prices) or a variable such as output or inflation may introduce some surprises. This new information generally changes the future behaviour of inflation—and, therefore, projections—and can even influence the MCPC views of how the economy is functioning, and particularly how different shocks are transmitted. Faced with new projections, it may be necessary to adjust monetary policy, which modifies projections. Within the inflation targeting framework, corrections to monetary policy aim to push expected inflation back toward the midpoint of the target range over the policy horizon.

- Second to confirm the degree of stimulus expected from monetary policy, in line with previously prepared projections, when new information tends to confirm the original reasons for this stance. Even where there is no news of significant changes, a change to the monetary policy rate may be warranted to confirm a certain path expected from the monetary stimulus assumed in projections.

5. Transparency, accountability and effectiveness

- The need for the BOU to achieve greater transparency and better communication with economic agents stems from two mutually entwined principles for maximizing monetary policy: accountability and effectiveness. The Central Bank's own autonomy requires greater accountability in delivering transparent information on its actions. In response to this challenge, the Bank's communication with the public must enjoy top priority on its agenda.

- To ensure an accurate interpretation of the rationale behind shifts, it is important that the public understand the Central Bank's actions and that the latter be systematic.

- Policy surprises should be the exception and not the rule, so the public can use the information available to predict the most likely path of monetary policy and thus enhance its effect.

- Transparency and communication are even more important when monetary policy is based on the projected inflation trend. The ability to transmit the rationale behind the inflation projection and how the Central Bank will respond underpins the credibility of both the policy itself and the Central Bank's commitment to price stability.
- Nonetheless, on occasion some degree of discretion may be appropriate; for example, on some matters, such as stability and regulation, the central bank may opt for providing less information to achieve its ultimate goal, stability.
- In practice, monetary policy transparency means more and better communication from central bank.