BANK OF UGANDA

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To members of the Uganda Manufacturers' Association

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The Depreciation of the Exchange Rate and its Implications for Manufacturing Industry

Introduction

Good morning Ladies and Gentlemen. I would like to begin by thanking the Chairman of the Uganda Manufacturers' Association for kindly inviting me to speak to you this morning.

Many people in the business community are concerned about the developments in the exchange rate. Over the course of the 2014/15 fiscal year, which ended on Tuesday, the Ugandan Shilling depreciated against the US dollar by 27 percent. Uganda is, however, not alone in this respect. The Tanzanian Shilling fell by 20 percent, the South African Rand by 15 percent and the Kenyan Shilling by 13 percent in 2014/15. Even major international currencies fell heavily against the dollar in this period; the Euro and the Japanese Yen fell by 22 and 21 percent respectively. Many emerging and frontier markets have suffered similar problems to Uganda over the last 12 months because export commodity prices have fallen, demand in key export markets has weakened and it has become more difficult to mobilise capital on international markets.

For Ugandan importers and exporters, the most relevant measure of the exchange rate is the trade weighted exchange rate index, which is based on a basket of currencies from the countries with which Uganda conducts international trade. The trade weighted exchange rate index depreciated by 17.5 percent in 2014/15.

Why did the Shilling depreciate in 2014/15?

Uganda has a market determined exchange rate. As such the strength of the supply of, and demand for, foreign exchange are the main factors which determine the exchange rate. Developments in the balance of payments (BOP) determine the supply of, and demand for, foreign exchange. In the 2014/15 fiscal year, Uganda's BOP deteriorated as a consequence of several factors.

First, Uganda's current account deficit widened in 2014/15 by an estimated $700 million, to almost $2.9 billion. This was mainly because our exports of goods and services fell in the last fiscal year, as a result of lower global commodity prices, problems in regional markets such as that of South Sudan, and a drop in tourism arrivals. Despite the fall in the price of oil, which enabled Uganda to reduce its fuel import bill, imports of goods and services increased, partly because of higher Government spending on imports related to infrastructure projects but also because of stronger demand from the private sector for non-oil imports.

As a result of these adverse trends in our imports and exports, our trade deficit in goods and services was larger by $582 million in 2014/15. As a percentage of GDP, our trade deficit was estimated at 12.1 percent in 2014/15 compared to 10.2 percent in the previous fiscal year. This means that, for every 100 Shillings of goods and services produced in Uganda, we actually absorbed 112 Shillings in consumption and investment spending. In addition to the larger trade deficit, dividend payments by foreign owned companies were higher by almost $250 million, which reflects a recovery in corporate profits in 2014/15, and this also contributed to the widening of the current account deficit.

Our current account deficits have to be financed by surpluses on the financial account (this is what used to be referred to, in the terminology of the balance of payments, as the capital account). However, while the current account deficit widened in 2014/15, the surplus on the financial account failed to keep pace. This was mainly because of a fall of almost $240 million, or about 20 percent, in inflows of foreign direct investment (FDI), which is the single largest component of the financial account. The fall in FDI in the last fiscal year was mainly because of lower foreign investment in the oil industry, caused by the fall in the global price of oil and delays in reaching agreements between the oil industry and Government on issues related to the development of the sector in Uganda.

Because the financial account surplus was not large enough to fully finance the current account deficit, Uganda incurred an overall BOP deficit in 2014/15, and hence a fall in foreign exchange reserves, which is estimated at $535 million. We had expected to incur an overall BOP deficit in 2014/15, because of the large Government payments to the contractors for the Karuma and Isimba hydro power projects, but the deficit was much wider than we had originally forecast because the external environment was much worse than had been anticipated, and this adversely affected export earnings for both goods and services.

What are the prospects for 2015/16?

Unfortunately there is little prospect for substantial improvement in the external economic environment in 2015/16. Global economic growth is forecast to remain weak and there is no immediate prospect of a recovery in demand from South Sudan, which is our largest export market. Nevertheless, I expect a modest improvement in the BOP in this fiscal year for two reasons.

First, the exchange rate depreciation which has taken place over the last l6 months, since February 2014, should have strengthened the competitiveness of our traded goods industries and boosted demand for our exports. For example, it will be cheaper for tourists to visit Uganda. This should help to bring about a small narrowing of the trade deficit in goods and services.

Secondly, we are forecasting a rebound in FDI, especially related to the oil industry, and financial inflows for the large energy projects of Karuma and Isimba, which will contribute to a larger financial account surplus. Consequently, I hope that we will be able to achieve an overall BOP surplus in 2015/16 and thus accumulate foreign exchange reserves. Our target is to increase foreign exchange reserves by just over $250 million in the current fiscal year.

How does the depreciation of the exchange rate affect manufacturing industry?

Manufacturing firms are among the largest users of foreign exchange in Uganda, especially because many material inputs are imported along with most capital equipment used by manufacturers. Depreciation will make these inputs more expensive. However, most manufactured goods are what economists call "traded goods' which means that potentially they can be traded across international borders. Traded goods are either exported or are sold in the domestic market but face competition from imports. As such, the real exchange rate matters for the competitiveness of traded goods. A real depreciation of the Ugandan exchange rate makes Uganda's traded goods cheaper relative to their foreign produced competitors and, therefore, should boost demand for the Ugandan goods, whether in the domestic market or in export markets. This is the case even for industries which have to import most of their inputs, because the depreciation affects both the value of their output and their material inputs, and the former should always exceed the latter. Although it may take time for production to expand in response to improved competitiveness, in the long term real depreciation should lead to faster growth of traded goods industries in Uganda, including manufacturing industries.

What are the policy implications?

Uganda adopted a flexible, market determined exchange rate in the early 1990s, because it offered two crucial advantages over a fixed, or pegged, exchange rate. First, exchange rate flexibility helps the economy to adjust to external shocks, for example by improving the competitiveness of traded goods industries when there is a negative shock. Second, it provides a mechanism for maintaining BOP sustainability, and thereby avoiding the risk of BOP crises of the type which afflicted Uganda in the 1980s. Exchange rate flexibility has contributed to the sustained growth of the Ugandan economy over more than 20 years.

In the face of the worsening external economic environment which has faced our economy, exchange rate depreciation is unavoidable. It is not sustainable for the Bank of Uganda to try and prop up the exchange rate, at levels which are not consistent with supply and demand in the foreign exchange market, by intervening and selling foreign currency. The BOU would simply deplete its foreign exchange reserves if it attempted to do this. Furthermore, as I have already mentioned, depreciation can help the Ugandan economy adjust to a more challenging external environment, by boosting the competitiveness of traded goods industries, including manufacturing industries, and by encouraging Ugandans to purchase domestically produced goods rather than imports.