THE ROLE OF THE CENTRAL BANK RATE IN CONTROLLING INFLATION IN UGANDA

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ABSTRACT

For the past two decades, Uganda has pursued a robust macroeconomic management policy of achieving levels of inflation below the 5% target. However, there have been episodes of increasing inflationary pressures which have led to an extensive debate on whether the central bank rate can be applied as a feasible instrument to control inflation. This study examined the role of the central bank rate in controlling inflation in Uganda. Time-series data for the period 1990 -2015 was used to examine the impact of the central bank rate on inflation. Officials from the Bank of Uganda were also interviewed to provide their views on the role of the Central Bank Rate in controlling inflation. The co-integration technique established the relationship between central bank rate and inflation. Results suggest that the central bank rate has a negative impact on inflation implying that an increase in the central bank rate reduces inflation. The study also revealed that there were two co-integration equations in the period under consideration.

The Interviews with Central Bank officials revealed that in order for the CBR to be effective in fighting inflation, interest rate channel should be effective, there should be a wide financial sector, strong transmission mechanism and interest rates should be high enough to curtail excess liquidity through borrowing by the private sector.

The study also found that limitations to the effectiveness of the Central Bank Rate includes; External shocks, Structural issues, Non-compliance of commercial banks and limited financial literacy within the general population and investors who obtain loans from foreign-based institutions at lower rates.

These results have important policy implications for both domestic policy-makers particularly the central bank in controlling inflation in Uganda. While the CBR is a feasible instrument for controlling inflation in Uganda, it is effective in cases where there is a good level of compliance by the commercial banks, a relative high lending interest rate to mop up excess liquidity and a good level of financial literacy among the population to respond appropriately to changes in the CBR. The study concludes that all factors which cause an increase in the general price levels such as increase in money supply should be addressed with the appropriate policies so as to combat inflation.