# Uganda Shilling depreciation in FY2015/16: Can a re-occurrence be mitigated?

## OVERVIEW

The National Budget Framework paper for Financial Year 2016/17 approved by Parliament indicated that Government would pay interest on debt worth Ug shs 2 trillion up from Ug shs 1.65 trillion in the current Financial Year 2015/16. This rise in the interest payments for both domestic and external debt of Ug shs 350 billion reflects increased costs of borrowing and exchange rate depreciation

Exchange rate is the price of one country's money in terms of another's. The exchange risk includes depreciations and appreciations of the currency (Uganda shilling) that impact the free cash flows of a country. Local currency depreciation creates a need for increased resources to service the same level of foreign currency debt. An appreciation has the opposite impact.

In addition to debt service, depreciation of the currency necessitates additional resources for imports, missions abroad and foreign currency denominated contracts; all of which are budgeted for in Uganda Shillings but settled in foreign currency.

Repayment of foreign denominated debt increases the demand of foreign currency which exerts more pressure on the shilling. This policy brief assesses the Government's interventions to hedge against the re-occurrence of the shilling depreciation.

## KEY ISSUES

- The causes of the Uganda Shilling depreciation were largely external.
- The mitigation measures like reducing imports and boosting/diversifying exports are medium-term measures that may not easily be achieved.
- The GoU operates a flexible exchange rate and cannot have absolute control on the level of exchange rate.

## INTRODUCTION

The exchange rate used for the budget for the FY2015/16 was Ug shs/$3,098 however, for the first 8 months of FY2015/16 the Ug shs/$ exchange rate fluctuated as indicated in table 1.

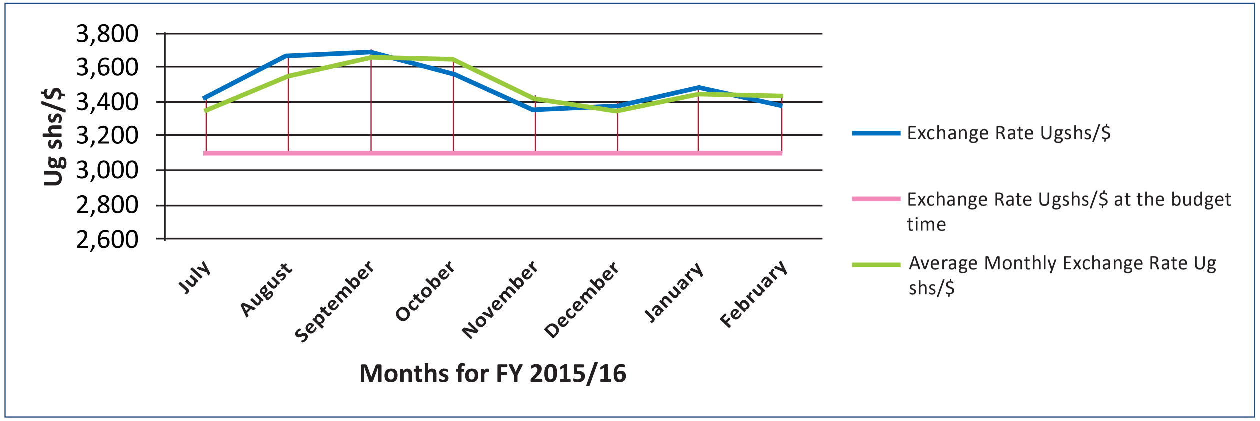
When the exchange rates were applied to the actual outturns of interest payments for the period July to February 2016, it was noted that Ug shs 15.053 billion was lost on account of exchange rate depreciation and could further rise up by 30th June 2016.

Table 1: Monthly Exchange Rate and Interest Payments on External Debt as at end of month (July 2015-February 2016)

| Month | July | August | September | October | November | December | January | February | Total |
|---|---|---|---|---|---|---|---|---|---|
| Exchange rate shs/$ month end | 3,430 | 3,663 | 3,700 | 3,565 | 3,362 | 3,382 | 3,484 | 3,383 | |
| Average month exchange rate shs/$ | 3,360 | 3,548 | 3,667 | 3,636 | 3,429 | 3,362 | 3,451 | 3,435 | |
| Outturn Interest Payments $ | 3,466,409 | 1,310,614 | 7,508,741 | 2,436,360 | 2,154,263 | 4,536,202 | 10,821,029 | 6,623,350 | 38,856,968 |
| Outturn Interest Payments shs( 000) Avrg rate | 11,647,167 | 4,650,452 | 27,538,308 | 8,858,605 | 7,386,968 | 15,252,979 | 37,345,535 | 22,751,870 | 135,431,885 |
| Outturn Interest Payments shs (000) budget rate 3,098 | 10,738,935 | 4,060,282 | 23,262,080 | 7,547,843 | 6,673,907 | 14,053,154 | 33,523,548 | 20,519,138 | 120,378,887 |
| **Total loss in Ug shs (000)** | **908,234** | **590,169** | **4,276,228** | **1,310,762** | **713,061,053** | **1,199,825** | **3,821,987** | **2,232,731** | **15,052,998** |

*Source: BOU & MFPED*

Figure 1: Average Monthly Exchange Rates Ug shs/$ against Budget Rate FY2015/16




***Source: BOU & MFPED***

## Causes of the exchange rate depreciation

There are a number of causes for currency depreciations including local and foreign factors. The domestic factors form the main pressures and stem from the dollar demand-supply imbalance pressures from both public entities and private firms. Dollar demand is heavier with government and private firms demanding for both final and intermediary goods and services from foreign markets.

According to the Bank of Uganda (BoU) monetary policy reports for the months of August, October and December 2015, key to the exchange depreciation was:

- The global strengthening of the USD on account of strong economic performance amidst tight monetary policy, the shilling depreciated year on year by 40% against the United States Dollar (USD) to an average mid rate of Ug shs 3,668 in September 2015.
- Bloated import bill: Although the import bill declined by 9.2% to USD 1,527.1million, this was driven by drop in the value of oil imports, that declined by 34% on account of the drop in international oil prices. There was also a decline in private sector demand for non-oil imports by 8.2% from USD 1,144 million. However, the import bill remained bloated amidst predictions of increased private sector imports of consumer goods especially during the festive season. Additional factors that heightened the demand for foreign exchange included continued expenditure on public infrastructure projects.
- Increase in corporate demand on account of payment of dividends and profit repatriation by foreign owned companies.
- A reduction of inflows from Non Government Organizations (NGOs) and personal transfers in the Quarter to October 2015.
- Other unintended negative factors existed in the form of currency speculation especially in the run up to the presidential elections, noise and expectation as different economies compared to each other by offshore investors resulted into flight to quality and/or portfolio assets reallocation from Uganda.
- Supply on the other hand comes through export earnings and foreign direct investments;
- Reduced Exports: It was observed that exports were subdued as export receipts fell by 4.6% in the period ended October 2015 compared to the same period in the FY 2014/15. This was partly driven by declining commodity prices, for example Robusta coffee prices declined by 20.2%. Food prices, as measured by the Food and Agricultural Organization (FAO) food price index, declined by 2% monthly in the quarter to December 2015 affecting all major food commodity prices. Export earnings remained sluggish although receipts increased by 1% in quarter 4-2015
- Direct investment net inflows declined by 29% to USD 181 million. According to Bloomberg markets news foreign depreciation pressures arise from effects/implications of policy changes in the developed economies like the US, UK and Europe on developing economies. A shift in economic policies in the developed economies tends to trickle down into emerging market economies like Uganda through declines in demand for local exports, foreign direct investments and other project support. The interest rate hike of the US Fed rate in December was seen to negatively impact the shilling which depreciated by 2.6% month on month basis by January 2016 as offshore investors reallocated their dollars into US assets.

## Effects of the exchange rate depreciation

- Fast paced exchange rate depreciation is a negative supply shock for the economy, it raises the cost of supplying goods and services in the economy, because many of these goods and services are either directly imported or are produced locally but require imported inputs during their production. This effectively causes inflation, for example in the month of September 2015, headline inflation rose to 7.2% from 4.8% in August, reflecting a pass through of exchange rate depreciation to domestic prices.

- The shilling value of the foreign currency denominated loans grew on average by 39% in September and 36.8% in October on a year on year basis.

- Debt service tends to deprive the country of foreign exchange needed for importation of capital goods as it creates a liquidity constraint.

- Increased government expenditure on account of exchange depreciation exerts pressure on government budget, for instance, various missions whose budgets are met in foreign currency have had supplementary requests of Ug shs 14.9 billion on account of lost poundage.

## Government Interventions

Through BoU, government intervenes to stem volatility of the exchange rate, as was the case in the quarter ended August 2015 where BoU sold USD 50 million.

With effect from January FY2015/16, all local contracts with GoU are to be issued in Ug shs.

It is important to note that GoU operates a flexible exchange rate and cannot have absolute control on the level of exchange rate.

## Conclusion

The value of external debt tends to increase with depreciation in the exchange rate. This increases government costs and distorts the budget execution. The factors that led to the shilling depreciation included strong US dollar, falling global commodity prices, declining crude oil prices, a reoccurrence of the shilling depreciation cannot be ruled out considering that the causes discussed in this brief remain eminent. So far, GoU efforts to control for a plausible reoccurrence of the depreciation are modest and need augmentation as follows.

## Recommendations

- An import substitution strategy would address the bloated import bill for example by improving the public transport system, quality of locally manufactured medicines and used clothes would serve as substitutes to these imports highly imported commodities.

- Increase in the volume and variety of exports, through value addition and quality control reviews of exports. For example the tourism sector budget should be increased, specifically towards marketing Uganda which has a number of untapped tourist opportunities that if promoted would yield the requisite returns over the years.

- Operationalization of the local content policy of ‘Buy Uganda Build Uganda’ where companies investing in public infrastructure would have to procure raw materials locally for example cement from the local market as opposed to importing.

## References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7. Todd J & Hanley S Chiang (2003), “Other Costs of High Debt in Poor Countries 2003



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