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THE IMPACT OF INFLATION ON FINANCIAL SECTOR DEVELOPMENT IN UGANDA, 1980-2014

BY

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ABSTRACT

This dissertation sets out to empirically determine the relationship between inflation and financial sector development as well as the threshold level of inflation in Uganda. The study adopts annual time series data spanning over the period 1980 to 2014 and the variables used are; Inflation rate (CPI), GDP, Government Expenditure as a percentage of GDP, Trade Openness, Investment as a percentage of GDP. M2 and Domestic Credits to Private Sector (DCPS) were used to proxy financial sector development. The econometric technique used is the Autoregressive Distributing Lags (ARDL) model bound testing approach developed by Pesaran, Shin and Smith (2001). The model was later adjusted to fit the Khan and Senhadji (2001) method to capture the inflation threshold estimation.

The finding established a statistically negative long run relationship between inflation and financial sector development in Uganda. The coefficients of the Error Correction Terms (ECM) tells us that the rate of adjustment of the variables from short run to long run occurs at about 58 percent and 61 percent per year when DCPS and M2 respectively are used to proxy financial sector development. It has also been established that, financial sector development will drop by 0.013 when inflation increases by 1 percent when DCPS was used and 0.076 when M2 was used. The results also show that the inflation threshold level occurs at 4 percent. At inflation levels below 4 percent there is a positive but statistically insignificant relationship between inflation and FSD. Beyond 4 percent the relationship becomes negative and the intensity increases exponentially as the inflation rates increases. The main policy recommendation is therefore that, the central bank should concentrate on those policies that keep the inflation rate below or at 4-percent threshold for the financial sector to develop.