BANK OF BOTSWANA

2018 MONETARY POLICY STATEMENT

by

Moses D Pelaelo
Governor

February 27, 2018

Introduction

Distinguished Guests, it is my pleasure and privilege to welcome you, on behalf of the Board, Management and Staff of the Bank, to the launch of the 2018 *Monetary Policy Statement. Your gracing this occasion with your presence this morning is valued and highly appreciated.*

In today's message, following a brief introduction on the role and significance of the *Monetary Policy Statement,* I will cover four substantive issues. First, an outline of the operational initiatives to further strengthen policy effectiveness with respect to both price and financial stability; second, I will review economic growth and price developments in 2017; third, I will highlight the conduct of monetary policy, globally and here at home; and, finally, I will provide the inflation outlook for the medium-term and, consequently, the likely monetary policy posture during 2018.

Honourable Minister, Distinguished Guests, the launch and dissemination of the Monetary Policy Statement affirms the Bank's transparency and accountability in the formulation and implementation of monetary policy. In this regard, the Statement promotes an understanding of the conduct of monetary policy and its objectives and, accordingly, guides the public's formation of expectations. On this occasion, the Bank reports on price developments and inflation trajectory over the past year and policy performance as pronounced in the previous year's Statement. In turn, there is a prognosis of prospects for inflation going forward and guidance on how the Bank intends to respond and implement monetary policy this year.

A Brief Outline of the Monetary Policy Objective and Framework

The Bank's primary mandate is to maintain price stability and in a manner that will also safeguard the stability of the financial system. Both price and financial stability create a conducive monetary and financial environment for effective mobilisation of savings, sound credit allocation to the economy, productive investment and international competitiveness of domestic firms. It is equally important that the financial system, in particular the banking sub-sector, is sound and stable as it serves as the main transmission of monetary policy signals and facilitating economic activity through the provision of liquidity and risk mitigation. Therefore, the main objective is to foster a monetary environment that is aligned to, and supports, the national objective of sustainable and inclusive economic growth.

Improvements in Monetary Policy Framework

Esteemed Guests, the Bank continues to make **refinements to the monetary policy framework** to enhance effectiveness and impact on economic decisions as well as the growth and inflation trajectory. In the last year's statement, I outlined the evolution of the Bank's monetary policy framework in the past two decades, namely, first, clarity and definition of what the inflation objective is; second, identification of the medium-term performance horizon; third, development of supporting infrastructure and internal capacity for forecasting as well as policy analysis to guide monetary policy decisions; fourth, formalisation of the institutional arrangements for policy formulation and dissemination, such as the Monetary Policy Committee meetings and release of Policy Statements; and, fifth, changes in the exchange rate policy framework, in particular, the adoption of the crawling band exchange rate framework and public disclosure of the weights of the constituent currencies in the Pula basket as well as the annual rate of crawl.

These measured and carefully sequenced incremental changes are intended to set a clear framework to anchor policy credibility and predictability and, therefore, inform expectations and economic decisions. The more recent innovations, started last year, included pre-announcement of the dates for the Monetary Policy Committee meetings for the year ahead and media briefings that follow each meeting to announce and engage on the policy decision. Going forward, and in an effort to further improve on communication of economic and policy developments, the Bank will publish four Monetary Policy Reports each calendar year, including the Monetary Policy Statement.

The Monetary Policy Reports will be prepared for the February, April, August and October Monetary Policy Committee meetings and published not more than seven days later. Among others, the preparation of these reports and assessment of the economic outlook, as well as policy discussion, coincides with and will benefit from the release of the quarterly national accounts by Statistics Botswana, the biannual Business Expectations Survey conducted by the Bank and the Budget Speech. The June and December Monetary Policy Committee meetings will be supported by updates and evaluation of forecasts against ultimate outcomes for key variables. These regular updates are expected to similarly inform the policy decision. I must emphasise, however, that all the six meetings of the Monetary Policy Committee in a year are important and would involve a careful consideration of any of the three likely outcomes and policy signals: that is, either to increase, decrease or maintain the level of the policy interest rate, namely, the Bank Rate.

Distinguished Guests, in 2017, the Bank also introduced measures to enhance market efficiency and effectiveness of monetary operations, in particular to better align market interest rates to the policy stance. First, the relaxation on the quantum of Bank of Botswana Certificates that can be used to mop up excess liquidity in the banking system helped to address the apparent misalignment of the structure of market interest rates with the policy stance. Second, the range of securities eligible for use by commercial banks as collateral when accessing the Bank of Botswana's Overnight Credit Facility were broadened to include all listed Government securities regardless of maturity. This also applies to Pula denominated bonds issued by the International Finance Corporation in the Botswana market. Therefore, commercial banks should be able to manage liquidity more efficiently, with less reliance on the Bank of Botswana Certificates for collateral and prudential purposes. The combined net effect of these measures is expected to reduce further the cost of monetary policy implementation.

Distinguished Ladies and Gentlemen, with the permission of the Minister, I should also indicate that the Bank is in consultation with the Ministry of Finance and Economic Development to establish a Financial Stability Council for Botswana. The high-level Council will primarily comprise the Ministry of Finance and Economic Development, Bank of Botswana and the Non-Bank Financial Institutions Regulatory Authority with a primary focus on coordinated macro-prudential monitoring, analysis and response with respect to any financial system imbalances or distress. This recognises the shared responsibilities for regulation and supervision of the financial system, as well as for the design and implementation of financial sector legislation, policies, regulatory and oversight frameworks.

The Council should, therefore, reinforce collaboration, cooperation and communication amongst the relevant authorities to achieve comprehensive monitoring and enforcement of legislation and regulations in order to maintain integrity and stability of the financial system. Similar institutional arrangements are abound across the world and were, in particular, strengthened following the 2007/08 global financial crisis. Coordinated oversight is necessary because while the relevant institutions are distinctly and individually supervised at a micro level, the financial system encompasses interconnected relationships and activities and is subject to common and transferable risks. For example, in Botswana, households are net borrowers in their relationship with commercial banks and micro-lenders; however, the picture changes significantly when taking into account non-discretionary savings in the form of pension funds which, in the main, belong to the households. In turn, pension funds, corporates and other institutional investors are the largest depositors at commercial banks, accounting for approximately 76 percent of total deposits as at December 31, 2017.

Similarly, institutional investors are also significant shareholders for the banks listed in the Botswana Stock Exchange. Moreover, commercial banks are increasing their exposure to the property market, particularly desirable with respect to owner-occupied residential mortgages, while institutional investors are also heavily into property including financing the construction of shopping malls, thus vulnerable to common factors. It should also be added that, through the use of credit risk mitigation techniques, such as credit life insurance and guarantees, the insurance industry effectively serves as a warehouse of some risks emanating from lending institutions.

Distinguished Ladies and Gentlemen, it is, therefore, clear that the linkages between banks, non-bank financial institutions and financial exposure by businesses and households are intricate and symbiotic and, therefore, require a comprehensive oversight mechanism for the safety and soundness, as well as, the integrity of the financial system.

Global and Regional Economic Developments

Distinguished Ladies and Gentlemen, let me now turn to global and regional economic developments. Global GDP is estimated to have increased by 3.7 percent in 2017, higher than the growth of 3.2 percent in 2016. The improvement was broad-based and supported by strengthening demand, favourable financial conditions, improving labour markets, increasing commodity prices, as well as the resurgence in world trade. In emerging market economies, output expansion was led by robust economic performance in China and India.

International oil prices rose by 20.6 percent, supported by an agreement by some of the major producers to restrict production, concerns about possible supply disruptions arising from geopolitical tensions, as well as higher demand. In contrast, the average global food prices fell by 0.3 percent, while an improved harvest in Southern Africa contributed to a significant decline in staple food prices across the region. Overall, international oil and food prices exerted only marginal upward pressure on domestic inflation in 2017.

Global inflation was modest against the background of restrained demand and slow wage growth, albeit increasing slightly, from 2.8 percent in 2016 to 3.1 percent in 2017. Inflation was particularly subdued in the Special Drawing Rights (SDR) countries (comprising the United States of America, euro zone, China, Japan and the United Kingdom), increasing marginally from 1.7 percent in December 2016 to 1.8 percent in December 2017. During this period, in South Africa, inflation decreased from 6.8 percent to 4.7 percent. As a result, the trade-weighted average inflation for trading partner countries decreased from 4.2 percent in December 2016 to 3.1 percent in December 2017.

Domestic Economic Developments

In Botswana, inflation was low and stable around the lower bound of the 3 – 6 percent medium-term objective range in 2017 and in line with the prognosis in last year's Monetary Policy Statement. The low annual price increase was generalised across most categories of goods and services. Notably, food price inflation eased from 3.9 percent in 2016 to 1.1 percent in 2017. However, fuel prices increased by 9.5 percent compared to a decrease of 3.3 percent in 2016. Overall, the increase in administered prices, while individually large, added a modest 1.4 percentage points to inflation, given the relative weights in the consumer price basket, which is the index used to measure inflation.

In addition to the low impact of foreign inflation and changes in administered prices on domestic prices, aggregate demand pressures on inflation in Botswana were also restrained in the context of modest growth in personal incomes and commercial bank credit. The influence of government expenditure on demand was particularly constrained as indicated by a 3.6 percent contraction in government expenditure in 2017 compared to the 9.7 percent growth in the prior year. At the same time, a 2.9 percent average increase in wages in the nine months to September 2017 had a modest impact on demand and inflation.

The annual growth in commercial bank credit fell from 6.2 percent in 2016 to 5.6 percent, sustained by higher rates of increase in lending to private businesses and unsecured loans to households in 2017 compared to 2016. However, the lower rate of increase in lending for residential property and substantial loan repayments by parastatals contributed to reduced annual credit expansion.

Honourable Minister, esteemed Guests, **monetary policy implementation in 2017** varied at the global level, in response to mixed economic performance across countries and regions. It was predominantly accommodative in advanced economies, with low levels of interest rates and continued maintenance of liquidity support to the financial sector. Policy interest rates were kept low in the euro area, while the Bank of Japan maintained negative interest rates. Similarly, asset purchase programmes were maintained in both jurisdictions. However, interest rates were increased in the United Kingdom in order to move inflation towards the country's 2 percent target. In the United States of America, the Federal Reserve increased the target range for the federal funds rate by a cumulative 75 basis points in a move towards policy normalisation, but was still relatively low and accommodative by historical standards.

Monetary policy was also largely accommodative in emerging market economies as central banks, including the South African Reserve Bank, eased monetary policy to support economic activity against the background of low inflationary pressures.

Domestic Monetary Policy Implementation

For its part, the Bank continues to conduct monetary policy through a forecast-based policy framework that informs the appropriate response to deviations of inflation from the objective range. The analysis involves assessment of the divergence of actual output from potential output. Technically, this is known as the "output gap", which is the primary indicator of the direction of future inflation. The inflation forecast incorporates projections of foreign inflation, exchange rate movements and changes in domestic administered prices, consumption taxes and levies. In addition, the Bank evaluates risks associated with the projected outlook. In determining the appropriate policy response, the inflation forecast is considered alongside indicators of financial stability and economic activity, including relevant information from the Business Expectations Survey conducted biannually by the Bank.

During 2017, monetary policy was conducted in an environment of below-trend economic activity and a positive medium-term inflation outlook, providing scope for policy easing. Indeed, as you would be aware, the Bank Rate was reduced by half a percentage point to 5 percent in October. Accordingly, commercial banks also reduced the prime lending rate by half a percentage point to 6.5 percent.

Monetary policy implementation entailed the use of Bank of Botswana Certificates to mop up excess liquidity in an effort to maintain interest rates that are consistent with the monetary policy stance. Given the market innovations mentioned earlier and the policy stance, the amount of Bank of Botswana Certificates decreased from P7.9 billion in 2016 to P6.3 billion in 2017, while the yield on the 14-day instrument increased from 0.97 percent to 1.47 percent. Accordingly, the interest rate structure was normalised and market interest rates properly aligned to the policy rate.

Honoured Guests, as in the previous years, monetary policy was also implemented in a way that safeguards the stability of the financial system. The slower household credit growth was in line with the modest increase in personal incomes, while the restrained expansion in mortgage lending was deemed to be consistent with a weaker residential property market. In this respect, the ratio of non-performing loans to total credit was comparatively modest at 5.3 percent in December 2017, albeit higher than the 4.9 percent recorded in 2016. Overall, credit expansion was aligned to the pace of economic growth and underlying economic conditions and, also, the banking system was assessed to be generally healthy, sound and stable.

Economic and Policy Outlook

Distinguished Guests, as regards the **economic and policy outlook**, the global economy is expected to grow by 3.9 percent in 2018. The projected improvement is broad-based by geography and economic sectors, and reflects anticipated stronger growth in advanced economies, supported by favourable global financial conditions and acceleration in demand. In emerging market and developing economies, GDP is expected to increase by 4.9 percent in 2018, from an estimated 4.7 percent in 2017. Nonetheless, as indicated last year, global economic performance continued to be subject to risks associated with protectionist trade policies being pursued by some countries, likely financial vulnerabilities induced by easy financial conditions, geopolitical tensions, political uncertainty and adverse weather conditions.

Global inflation is forecast to increase slightly from 3.1 percent in 2017 to 3.3 percent in 2018. Given modest inflation and below-potential output, it is anticipated that monetary policy will remain accommodative in most economies to support economic activity, complemented by measures aimed at facilitating effective financial intermediation and fostering resilience of the financial sector.

Domestic Economy

Distinguished Guests, as the Honourable Minister of Finance and Economic Development indicated when delivering the 2018/19 Budget Speech, the domestic economy is forecast to grow by 5.3 percent in 2018, an improvement from the estimated 4.7 percent for 2017. Furthermore, the budgeted 13.9 percent expansion in government spending for the 2018/19 fiscal year should be supportive of growth in domestic demand. Government spending comprises elements that generate short-term growth-supporting demand and expansion of productive capacity, which, potentially, contribute to future growth prospects. In this regard, government expenditure is more effective in promoting sustainable and inclusive growth where spending is in the areas that generate a large multiplier effect, such as infrastructure development, improvements in human capital and inputs to production generally, as well as local procurement.

The exchange rate policy will continue to complement the monetary policy framework; and it augurs well for maintenance of international competitiveness of domestic industries and macroeconomic stability. As announced at the beginning of the year and consistent with Botswana’s trade pattern, the weights of the constituent currencies in the Pula basket are 45 percent for the South African rand and 55 percent for the SDR. Also, effective January 1 this year, the Bank implements a modest downward rate of crawl of 0.3 percent for the nominal effective exchange rate to stabilise the real effective exchange rate, given that domestic inflation is projected to be slightly higher than the forecast average inflation of trading partner countries, albeit remaining close to the lower bound of the Bank’s medium-term inflation objective.

Overall, both external and domestic pressures on inflation are expected to be benign, and it is projected that inflation will remain within the 3 – 6 percent objective range in the medium-term, although with a slight upward trajectory in the near-term. This forecast takes into account the possible increase in some administered prices. That said, let me underscore that any upward adjustment in these prices that is substantially beyond current projections presents upside risks to the inflation outlook. In contrast, downside risks to inflation arise from the expected modest growth in global economic activity, a possible decline in commodity prices and the tendency of technological progress to result in lower prices.

Conclusion and Monetary Policy Stance

Honourable Minister and Distinguished Guests, as I conclude**,** I would like to restate that current projections, based on available data, suggest that inflation in Botswana will, in the medium-term, remain within the Bank's objective range of 3 – 6 percent. This positive medium-term outlook for inflation is in the context of anticipated higher but below-trend GDP growth in 2018 and a sound and stable financial system. Therefore, prospective developments augur well for maintenance of an accommodative monetary policy that supports productive lending to businesses and households. The Bank's implementation of monetary policy will continue to focus on entrenching expectations of low, predictable and sustainable inflation, through timely responses to price developments, while, at the same time, taking due care to ensure that policy decisions are consistent with enduring financial stability and supportive of sustainable economic growth.

Indeed, it is important to note that the continuing success in containing inflation within the desired 3 – 6 percent objective range in the medium-term and using monetary policy and exchange rate to influence output growth and competitiveness in the short-term is dependent on productivity in the economy and the extent of financial inclusion. Thus, a sufficiently high level of productivity encourages savers, investors and financial institutions to deploy financial resources to support economic activity, given that the return generated would be high enough to enable profitable payback of the funds so deployed. On the other hand, it is only when there is a formal economic relationship between a great majority of businesses and individuals and the banks that changes in interest rates, for example, can affect saving and borrowing decisions on a large scale and, therefore, have the desired and anticipated effect on price developments, economic activity and employment creation.

Honourable Minister, Distinguished Guests; I thank you for your kind attention.