MID-TERM REVIEW OF THE
2017 MONETARY POLICY STATEMENT

1. INTRODUCTION

1.1 The Mid-Term Review (MTR) of the 2017 Monetary Policy Statement (MPS) examines price developments and the underlying causal factors in the first half of 2017. It also assesses key financial and economic developments that are likely to influence the inflation outlook and financial stability, in order to determine the likely monetary policy response in the second half of 2017. Publication of the review promotes policy credibility and an understanding of the Bank's monetary policy by anchoring public expectations of a low, predictable and sustainable level of inflation within the Bank's 3 – 6 percent objective range in the medium term.

1.2 As projected in the 2017 MPS launched in February, inflation remained low and stable in the first six months of 2017, albeit with a moderate increase from 3 percent in December 2016 to 3.5 percent in June 2017, while remaining within the objective range. Price developments reflected, in part, the upward adjustment of fuel prices and water, electricity and transport services tariffs in the first half of 2017. On account of the positive medium-term outlook for inflation, the Bank Rate was maintained at 5.5 percent in the first half of 2017.

1.3 The forecast for global economic growth in 2017[1] was revised upwards to 3.5 percent, from an earlier projection of 3.4 percent. The better prospects for the global economy reflect accommodative financing conditions and improving labour markets, particularly in advanced economies, as well as higher commodity prices. Domestically, annual GDP growth in the twelve months to March 2017 is estimated at 3.9 percent, mostly underpinned by improvements in diamond trade, services and construction. The mining sector continued to be a drag on output growth, albeit contracting by a slower rate of 10.3 percent in the year to March 2017 compared to a contraction of 21.3 percent in the corresponding period in March 2016.

2. MONETARY POLICY FRAMEWORK

2.1 The primary objective of the Bank's monetary policy is to achieve price stability, which is defined as a sustainable level of inflation that is within the medium-term objective range of 3 – 6 percent. The policy is also formulated with a view to safeguarding the stability of the financial system. A low and predictable level of inflation and a conducive financial environment foster savings mobilisation, productive investment and international competitiveness of domestic producers which, in turn, contribute towards the broader national objective of sustainable economic development and employment creation.

2.2 The monetary policy framework is forecast based, with a medium-term outlook that primarily guides the Bank's response to projected movements in inflation,

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[1] The forecasts for 2017 were revised upwards in the International Monetary Fund's WEO, April 2017 and maintained in the WEO Update, July 2017. For 2018, the global growth forecast was maintained at 3.6 percent from the January WEO Update. The estimated growth rate for 2016 was also revised upwards, from 3.1 percent to 3.2 percent, in the July WEO Update, reflecting higher growth outcomes in Iran and India.

while taking account of prospects for economic growth and developments relating to stability of the financial system. To this end, in assessing the policy stance, the Bank factors in projections of real monetary conditions[2] in the context of other relevant domestic and international economic and financial developments, and their impact on the output gap[3] and, ultimately, inflation. The policy framework also recognises the importance of communication to inform stakeholders in order to ensure transparency, generate desired market response and influence expectations. Accordingly, the Bank delivers a statement after each meeting of the Monetary Policy Committee (MPC) at a press briefing to allow for interaction with the media and dissemination of the Bank's policy stance. The Bank also pre-announces the dates for the MPC meetings.

3. ECONOMIC DEVELOPMENTS IN THE FIRST HALF OF 2017

(a) External Developments

3.1 In the first half of 2017, monetary policy responses were divergent across the world. Accommodative monetary policy was predominant in advanced countries as policymakers generally focused on achieving sustainable growth through a loose monetary policy stance (including low interest rates and liquidity support to the financial sector in the euro area, Japan and United Kingdom) and structural reforms to foster competitiveness in the long term. The USA Federal Reserve, on the other hand, continued to normalise its monetary policy stance and thus increased the federal funds rate twice in the first half of 2017, and has signalled plans to start gradually reducing its holdings of securities towards the end of the year, thus commencing the process of withdrawing monetary stimulus from the economy. Monetary policy in some emerging market economies was geared towards addressing the need to support growth, while in others it was focussed on combating inflationary pressures.

3.2 World inflation increased in the first half of the year, reflecting a combination of higher commodity prices, modest global demand and a reduction in spare capacity. Nonetheless, there has been notable moderation of inflation in some emerging market and developing economies (EMDEs) as the impact of currency depreciation on import prices dissipated. For Botswana's trading partner countries[4], average inflation decreased from 4.2 percent in December 2016 to 3.1 percent in June 2017. In particular, for the same period, South African inflation fell within the South African Reserve Bank's target range of 3 – 6 percent (moving from 6.8 percent to 5.1 percent), while for SDR countries, inflation eased from 1.7 percent to 1.5 percent in the same period.[5]

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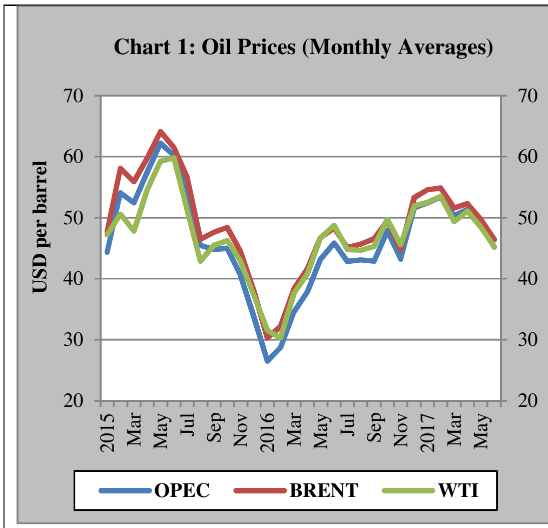
2 The real monetary conditions index (RMCI) measures the relative looseness or tightness of monetary conditions and gauges the likely effect that monetary policy would have on the economy through changes in the exchange rate and interest rates. The real monetary conditions are measured by the RMCI that combines, through a weighted average, the deviations of the real exchange rate and real interest rate from their respective trend values.

3 The output gap refers to the difference between actual output and long-term trend output (as an indicator of productive capacity). A negative output gap means the actual level of output for a given period is below the trend level for that period, thus indicating the economy is operating below its estimated potential. A positive output gap is the converse outcome.

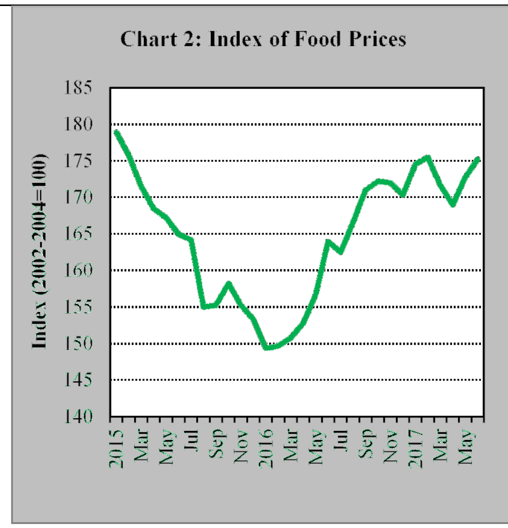
4 South Africa and the SDR countries (China, euro area, Japan, UK and USA).

5 Inflation in the UK breached the Bank of England's 2 percent target in the first half of 2017.

3.3 *Oil prices fell from an average of USD53.29 per barrel in December 2016 to USD46.37 per barrel at the end of June 2017 (Chart 1), despite the extension of the agreement by the Organisation of Petroleum Exporting Countries (OPEC) and some non-OPEC countries to cut production until March 2018. The cut in production in the first half of 2017 did not significantly reduce global oil supplies as it was partially offset by production gains in certain OPEC countries (Libya and Nigeria) that are not subject to the restrictions, as well as the increase in shale oil production in the United States. Moreover, the extended agreement, which maintained the existing ceiling on production levels, fell short of market expectations of deeper cuts. International food prices increased by 2.9 percent in the six months to June 2017 (Chart 2), reflecting higher cost of meat, cereals and dairy products, while prices of sugar and edible oils declined. Overall, movements in international oil and food prices did not significantly alter the domestic inflation rate in the first half of 2017.*



Source: OPEC and US Energy Information Administration



Source: Food and Agricultural Organisation

(b) Output and Price Developments in Botswana

3.4 *Real GDP increased by 3.9 percent in the twelve months to March 2017 compared to the revised annual decline of 1.8 percent for the corresponding period ending in March 2016. The stronger performance reflects growth of 5.9 percent in the non-mining sector in the year to March 2017 compared to 1.9 percent for the period ending in March the previous year. The sectors that led non-mining output growth were trade, hotels and restaurants (16.8 percent), transport and communications (5 percent) and construction (4.4 percent). Meanwhile, the mining sector contracted by 10.3 percent in the year to March 2017, compared to a larger contraction of 21.3 percent in the corresponding period ending in March 2016, as trading conditions in the diamond market improved.*

3.5 *The moderate increase in economic activity, alongside slow growth in personal incomes[6] (and the associated weak demand pressures) resulted in benign inflationary pressures in the first half of 2017. In addition, the modest impact of*

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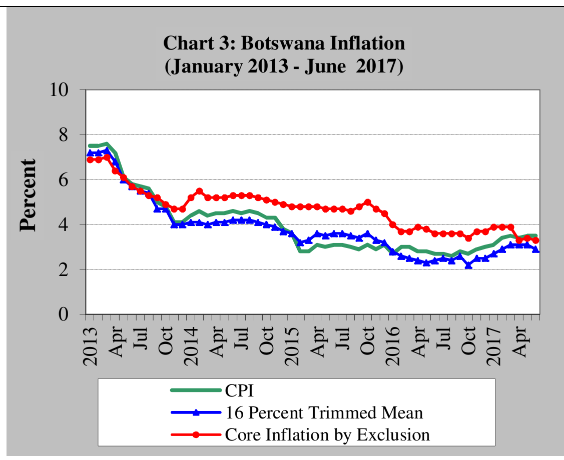
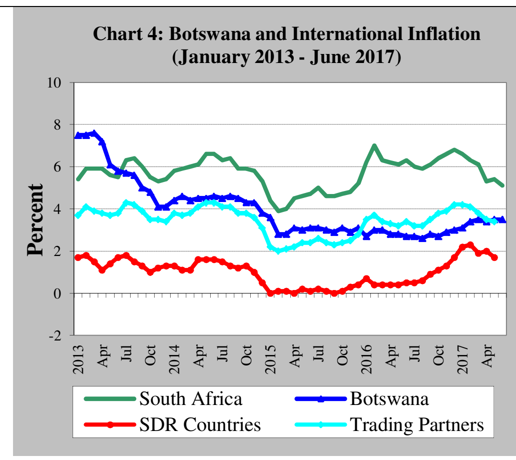
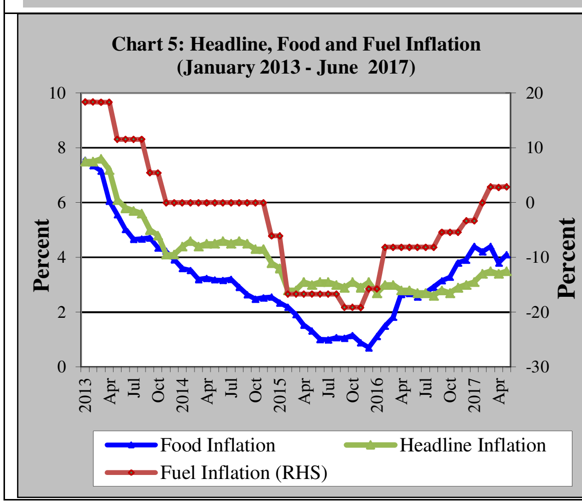
[6] *Government increased civil service salaries by 4 percent in April 2017 and by 7 percent for those unionised workers who had not been awarded the 3 percent increase in 2016.*

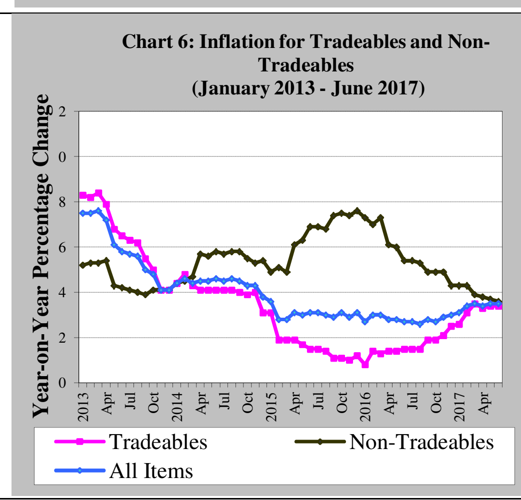
the net increase in administered prices (fuel prices and electricity, water and transport services tariffs) had a moderate impact on inflation. External pressures on domestic prices were also restrained against the backdrop of low inflation among trading partner countries and the relatively stable Pula exchange rate. Therefore, domestic inflation was stable around the lower end of the Bank's medium-term objective range in the first half of 2017.

3.6 *Inflation increased from 3 percent in December 2016 to 3.5 percent in June 2017 and was within the Bank's objective range of 3 – 6 percent (Chart 3). In particular, fuel inflation increased by 2.9 percent in the twelve months to June 2017, following a 3.3 percent decrease in the year to December 2016, while food inflation increased from 3.9 percent to 4.3 percent in the same period (Chart 5). On average, the adjustment of administered prices in the first half of 2017 contributed approximately 0.88 percentage points to inflation in the first half of 2017. Inflation excluding administered prices decreased from 3.7 percent in December 2016 to 3.3 percent in June 2017, while the 16 percent trimmed mean measure of core inflation increased from 2.5 percent to 2.9 percent in the same period.*









Source: Statistics Botswana and Bank of Botswana

(c) Government Expenditure, Credit Developments and Financial Stability Indicators

3.7 According to the preliminary outturn[7], total government spending is estimated to have increased by 6 percent in the 2016/17 fiscal year, compared to an increase of 5 percent for the 2015/16 fiscal year. Within this total, development and recurrent expenditure increased by 18.4 percent and 2.1 percent, respectively, in the fiscal year 2016/17.[8] The associated estimated budget deficit is P 2 billion, which is higher than the initial projection of P 1.1 billion. This larger deficit is mainly a result of an increase of P 1.5 billion in development expenditure to finance the Botswana Power Corporation in the third quarter of the 2016/17 fiscal year.

3.8 Annual growth in commercial bank credit was 4.1 percent in June 2017, lower than the yearly increase of 6.2 percent in June 2016, against the background of moderate economic activity and restrained growth in personal incomes. In particular, the year on year increase in lending to households fell from 7.6 percent to 5 percent in this period. The yearly growth in lending to the business sector decreased from 4.2 percent in December 2016 to 2.8 percent in June 2017; some large loans were repaid by parastatals. Excluding parastatals, the annual increase in borrowing by businesses rose from 7.4 percent in December to 9.5 percent in June 2017.

3.9 Banking sector performance indicators, including levels of capital, liquidity, profitability and default ratios, suggest a stable financial environment. Even then, the aggregate ratio of non-performing loans (NPLs) to total loans increased from 4.9 percent in December 2016 to 5.3 percent in June 2017. The slight deterioration in asset quality experienced by the banking sector is attributed to, in the main, challenges for some diamond cutting and polishing businesses, job losses resulting from the closure of BCL group of companies and ongoing retrenchments by some major employers, as well as weaker market for high-value residential properties. The NPL to total loans ratio for individual banks ranged from 0.2 percent to 10.8 percent in June 2017. Households account for a larger share of total lending by commercial banks, which stood at 59.6 percent in June 2017. Annual growth in mortgages moderated to 4.4 percent in June 2017, from 7.3 percent in June 2016, which mainly reflects a weak housing market, especially at the upper-end, and tighter lending criteria by some banks. Nevertheless, unsecured household lending, which constitutes a large proportion of commercial bank credit, represents relatively small amounts spread across many borrowers of differing credit profiles, which mitigates associated financial stability risks. Overall, current levels of credit growth continue to be supportive of economic activity and augur well for durable stability of the financial system.

4. MONETARY POLICY IMPLEMENTATION IN BOTSWANA IN THE FIRST HALF OF 2017

4.1 Domestic monetary policy was implemented in the context of below-trend economic growth (a non-inflationary output gap) and a positive medium-term outlook for inflation. Inflation was restrained by slow growth in personal

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7 These are unpublished and subject to revision.

8 These estimates represent 93 percent and 102 percent of the revised budget for development and recurrent expenditure, respectively.

incomes, moderate increase in credit and the resultant subdued domestic demand. Furthermore, foreign inflation was low on average, with benign pressure on domestic prices. Hence, the Bank Rate was maintained at 5.5 percent for the first half of the year. The current level of interest rates is considered appropriate to support economic activity, mobilisation of financial resources (including deposits) and financial sector development.

4.2 *Monetary policy implementation entailed the use of Bank of Botswana Certificates (BoBCs) to absorb excess liquidity to ensure maintenance of interest rates that are consistent with the monetary policy stance, while reverse repurchase agreements were used to smoothen daily liquidity fluctuations. The value of outstanding BoBCs was P7.4 billion in June 2017.*

4.3 *The movement of money market interest rates was mixed in the first half of 2017, mostly influenced by supply/demand factors in specific market segments given an unchanged monetary policy stance (Chart 7).[9] The yield on the 14-day BoBC increased from 0.84 percent at the end of December 2016 to 1.34 percent at the end of June 2017, while for the 3-month BoBC, the yield rose from 1.01 percent to 1.31 percent in the same period. This followed a more accommodative supply of BoBCs aimed at improving policy transmission. In contrast, the 88-day commercial bank deposit rate fell from 2.03 percent in December 2016 to 1.69 percent in June 2017, while the average prime lending rate of commercial banks was constant at 7 percent in the same period. The real 3-month BoBC yield decreased from -1.93 percent to -2.12 percent, reflecting the smaller increase in the nominal interest rate compared to the increase in the rate of inflation between December 2016 and June 2017. Similarly, the real prime lending rate decreased from 3.88 percent in December 2016 to 3.38 percent in June 2017.*

4.4 *In January 2017, the weights in the Pula Basket for the South African rand and SDR were revised from 50 percent each to 45 percent and 55 percent, respectively. At the same time, the annual rate of crawl of the Pula exchange rate was reduced from an upward rate of crawl of 0.38 percent to 0.26 percent due to a narrower forecast inflation differential between Botswana and trading partner countries for 2017 than the inflation differential in 2016. The trade-weighted nominal effective exchange rate (NEER) thus appreciated by 0.13 percent in the six months to June 2017. Bilaterally, the Pula depreciated by 0.4 percent against the South African rand, but appreciated by 4.3 percent against the SDR in the same period. Given marginal inflation differential between Botswana and trading partner countries and the small rate of crawl, the real effective exchange rate (REER)[10] of the Pula was virtually stable (0.4 percent appreciation) in the six months to June 2017.*

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9 *Quoted yields are based on the weighted average of the winning bids at the auctions.*

10 *The REER is calculated using Botswana's headline inflation, weighted average inflation for SDR countries and South African headline inflation.*

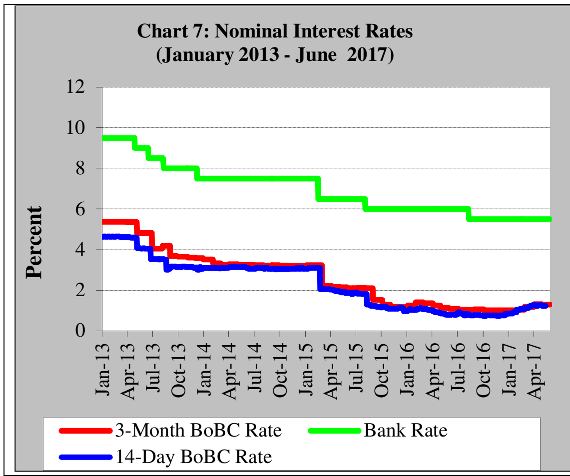

Chart 7: Nominal Interest Rates (January 2013 - June 2017)

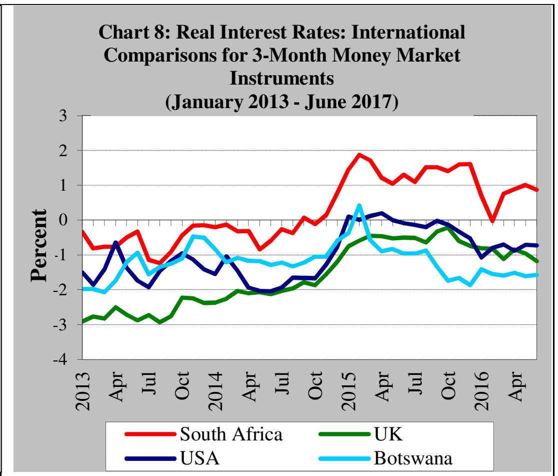

Chart 8: Real Interest Rates: International Comparisons for 3-Month Money Market Instruments (January 2013 - June 2017)

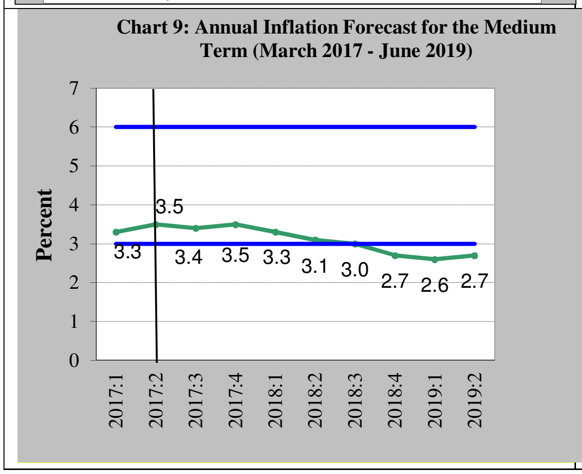

Chart 9: Annual Inflation Forecast for the Medium Term (March 2017 - June 2019)

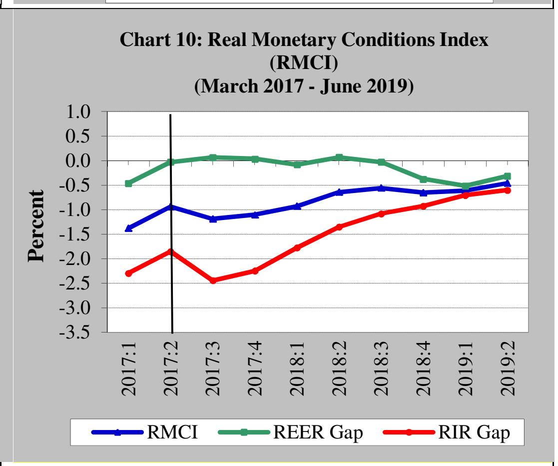

Chart 10: Real Monetary Conditions Index (RMCI) (March 2017 - June 2019)

Source: Bank of Botswana.

Notes:
1. *The REER Gap is a measure of the deviation of the REER from its trend value.*
2. *The Real Interest Rate (RIR) Gap is a measure of the deviation of the real interest rate (i.e., 3-month real BoBC rate) from its trend value.*
3. *RMCI is a weighted sum of the REER gap and RIR gap.*

4.5 *Developments with respect to the REER and real interest rates resulted in easing of real monetary conditions in the first half of 2017, reflecting the dominance of the real interest rate gap over the REER gap. The mildly accommodative real monetary conditions would potentially contribute to recovery in economic activity in the medium term.*

5. *MEDIUM-TERM OUTLOOK: OUTPUT AND INFLATION*

5.1 *Global output is forecast to increase by 3.5 percent in 2017 and by 3.6 percent in 2018, higher than the growth of 3.2 percent in 2016, while output growth for major economies is projected at 2 percent in 2017, slightly higher than the 1.7 percent in 2016. In EMDEs, growth is expected to increase from 4.3 percent in 2016 to 4.6 percent in 2017, against the background of modest global demand and higher commodity prices.*[11] *However, there are downside risks to global economic activity, including the prevailing policy uncertainty in the USA, as well as the emerging tendency towards protectionism, geopolitical tensions and persistence of tight financing conditions in some key markets. In South Africa, GDP is forecast to grow by 1 percent in 2017 (from 0.8 percent previously*

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[11] *The July WEO Update revised upwards the forecast for EMDEs' output growth rate for 2017, from 4.2 percent.*

forecast) compared to 0.3 percent in 2016. The South African economic prospects continue to be constrained by structural challenges, uncertainty and weak business sentiments. The downgrade of South Africa's foreign debt to sub-investment grade (by Standard and Poor's and Fitch) and prospects for further downgrade by the rating agencies weigh down on public sector investment through higher borrowing costs and difficulty in accessing funding.

5.2 *It is expected that inflationary pressures will remain restrained, reflecting stable commodity prices and modest growth in global economic activity. Therefore, global inflation is projected to average 3.5 percent in 2017, higher than the 2.8 percent in 2016. Overall, it is expected that foreign price developments will have a benign influence on domestic inflation. In particular, it is anticipated that inflation for trading partner countries will average 4 percent in 2017, mostly reflecting higher inflation in South Africa, where headline inflation is forecast to average 6.2 percent[12] in 2017, and to be within the 3 – 6 percent target range for the remainder of the year. Nonetheless, it is envisaged that the relative strength of the Pula against the South African rand will moderate imported inflation.*

5.3 *Domestic non-mining output expansion is projected to remain below trend in the medium term, influenced mainly by the restrained growth in personal incomes, moderate increase in government expenditure and modest economic growth in major trading partners. However, gradual recovery is expected in the medium term in response to the loose monetary conditions. Overall, inflation is forecast to breach the lower bound of the 3 – 6 percent objective range in the medium term.[13] Upside risks to the inflation outlook relate to any considerable upward adjustment in administered prices and government levies and/or taxes and any increase in international oil prices beyond current forecasts, as well as any significant upward deviation in regional food prices from international trends. Nevertheless, there are downside risks associated with restrained global economic activity and the potential fall in commodity prices.*

5.4 *It is projected that monetary conditions will continue to be accommodative in the short to medium term, largely on account of negative real interest rates. The accommodative monetary policy stance is supportive of growth in economic activity going forward. Even then, structural constraints, possible instability in the supply of inputs and utilities,[14] as well as external and weather shocks could have adverse impact on growth.*

6. MONETARY POLICY STANCE IN THE SECOND HALF OF 2017 AND MEDIUM TERM

6.1 *The current state of the economy and the projected performance as well as the prospects for the financial sector, along with the positive inflation outlook, suggest that maintaining an accommodative monetary policy stance is consistent with keeping inflation within the 3 – 6 percent objective range in the medium term. Furthermore, the potential for banks to expand credit provision continues to*

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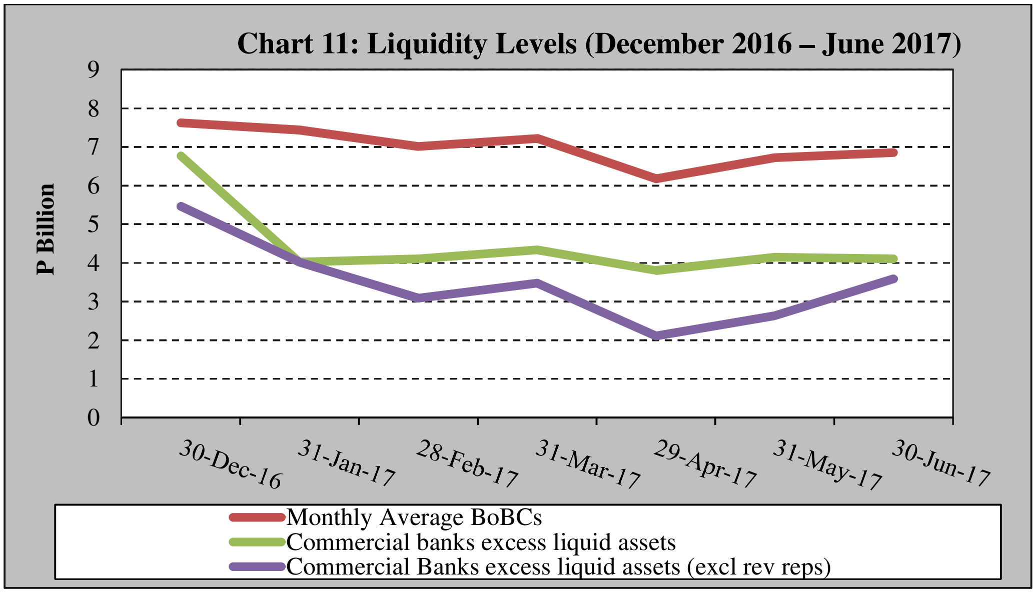
[12] *IMF's WEO, April 2017. However, the South African Reserve Bank has forecast headline inflation in South Africa to average 5.3 percent and 4.9 percent in 2017 and 2018, respectively.*

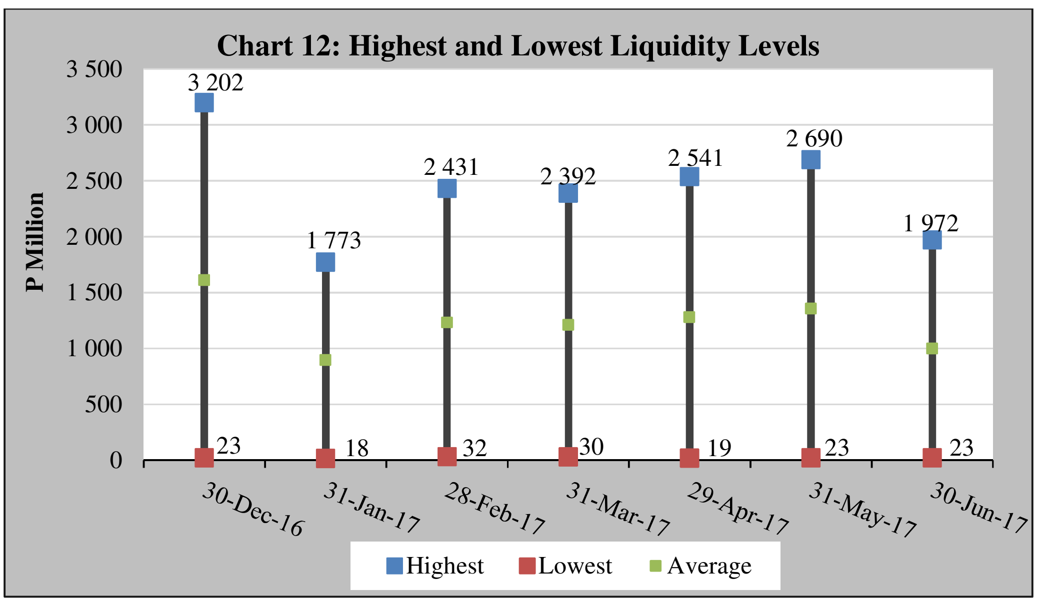
[13] *As reported in the March 2017 Business Expectations Survey, businesses expect inflation to remain within the objective range in 2017 and 2018.*

[14] *Previously, disruptions to supply of electricity and water weighed down significantly on economic performance, while unstable mobile and internet connectivity is also potentially disruptive and costly to economic activity.*

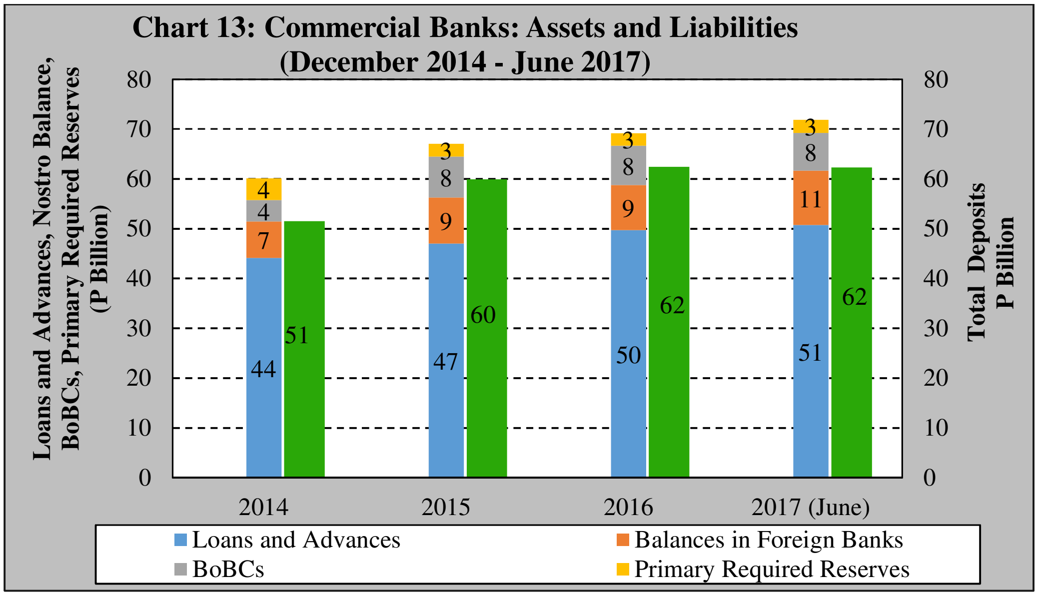
be supported by a stable financial system and sufficient liquidity in the banking system (Charts 11-13). In particular, the level of Bank of Botswana Certificates and balances held by banks abroad, in part, represent excess liquidity, which is available for lending in response to any effective credit demand by both businesses and households.



Source: Bank of Botswana and commercial banks.



Source: Commercial banks.



Source: Commercial banks.

6.2 *The Board of the Bank has approved broadening the range of securities that are eligible for use by commercial banks as collateral when accessing credit facilities offered by the Bank. By allowing all government securities, regardless of maturities to be used for this purpose, commercial banks will be able to manage liquid assets more efficiently, with less reliance on BoBCs for collateral. In turn, this should improve the efficiency of the policy transmission mechanism, while also reducing further the costs of monetary policy implementation. The new framework will become operational in the second half of 2017.*

6.3 *The Bank's implementation of the exchange rate policy will continue to entail a 0.26 percent upward rate of crawl of the NEER for the remainder of 2017, given that inflation in Botswana is projected to be within the medium-term objective range of 3 – 6 percent and below the projected average inflation of trading partner countries.*

7. *SUMMARY AND CONCLUSION*

7.1 *Inflation increased, but remained within the Bank's objective range of 3 – 6 percent in the first six months of 2017, against the background of benign domestic demand pressures, modest wage growth and impact of the increase in administered prices, as well as favourable foreign price developments. Thus, the Bank considered that maintenance of an accommodative monetary policy was consistent with achieving the inflation objective in the medium term and appropriate for stimulating economic growth.*

7.2 *Looking ahead, inflation is forecast to breach the lower bound of the Bank's objective range in the medium term. The Bank's formulation and implementation of monetary policy will focus on entrenching expectations of low and sustainable inflation, through timely response to price developments, while ensuring that credit and other market developments are consistent with the maintenance of financial stability. The Bank remains committed to responding appropriately to ensure price and financial stability without undermining growth in economic activity.*