



MONETARY POLICY STATEMENT 2015

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1. INTRODUCTION

- 1.1 The 2015 Monetary Policy Statement (MPS) reviews the previous year's economic and policy developments and evaluates the factors that influence prices and their impact on inflation in Botswana. The Statement also assesses prospective economic and financial developments that are likely to influence the inflation path in the medium term and, in turn, the Bank's policy choices in 2015. In this respect, the MPS aims to promote an understanding of the monetary policy framework in order to anchor public expectations for a low, credible and sustainable level of inflation. Price developments and policy choices are assessed in the context of the Bank's medium-term inflation objective range of 3 – 6 percent and the financial stability objective.*
- 1.2 World economic activity expanded modestly in 2014, with mixed performance across countries and regions. Economic growth strengthened in the USA and UK, but remained weak in the euro area and Japan, while moderating with respect to emerging market economies. In an environment of falling energy prices and persistent excess capacity in major economies, inflation was low globally. In the circumstances, several central banks maintained an accommodative monetary policy, which included low interest rates and injection of liquidity.*
- 1.3 The domestic economy grew by 4.8 percent in the twelve months to September 2014, with significant contributions by both the mining and non-mining sectors. Inflation was within the Bank's medium-term objective range of 3 – 6 percent during 2014; it fell from 4.1 percent in December 2013 to 3.8 percent in December 2014.¹ Price developments were in the context of modest demand pressures as influenced by the monetary policy stance, and sluggish growth in incomes. Accordingly, the policy stance complemented modest foreign inflation in the context of prevailing domestic demand conditions.*
- 1.4 The Bank Rate was maintained at 7.5 percent in 2014 on account of the positive medium-term outlook for inflation. The policy stance also reflected consideration of the potential impact on financial stability of the relatively fast growth in household credit occurring alongside the slower increase in incomes. The Bank also implemented a 0.16 percent downward crawl of the nominal effective exchange rate (NEER) of the Pula, as the inflation objective was marginally higher than forecast inflation of trading partner countries. The result was that the Pula appreciated by 1.7 percent against the South African rand, and depreciated by 2.4 percent against the SDR.² The real effective exchange rate (REER) was relatively stable, thus supportive of international competitiveness of producers of tradeable goods and services.*
- 1.5 It is anticipated that inflation will remain within the objective range in the medium term and closer to the lower bound of the range during 2015. Upside risks to the*

1 Inflation fell further to 3.6 percent in January 2015.

2 The SDR is the unit of account of the International Monetary Fund comprising the United States dollar, British pound, Japanese yen and euro.

inflation outlook relate to any substantial increase in administered prices and government levies. The inflation outlook is also subject to downside risks associated with weak global economic activity and a possible further decline in commodity prices.

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. Additionally, policy is formulated with a view to safeguarding the soundness and 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; in this way contributing towards the broader national objective of sustainable economic diversification and development.

2.2 The monetary policy framework is forecast-based, with a medium-term outlook that primarily guides the Bank's response to movements in projected inflation, while taking into account prospects for economic growth and developments relating to financial stability. The main elements of the policy framework are as follows:

- (a) generation of a broad-based medium-term inflation forecast, and an assessment of both the “output-gap”³ and “real monetary conditions”⁴, as well as an estimate of the impact of changes in administered prices and government levies;*
- (b) assessment of additional information not incorporated in the inflation forecast, including the twice-yearly Business Expectations Survey and other supplementary data sources;*
- (c) evaluation of financial and other indicators that can impact on the safety, soundness and stability of the financial system, including credit and deposits, liquidity conditions and property market developments, as well as economic growth and employment prospects;*
- (d) regular meetings of the Bank's Monetary Policy Committee (MPC) to review recent economic developments, related inflation outlook and implications for monetary policy, as well as prompt dissemination of decisions to foster policy credibility and help anchor inflation expectations;*

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.

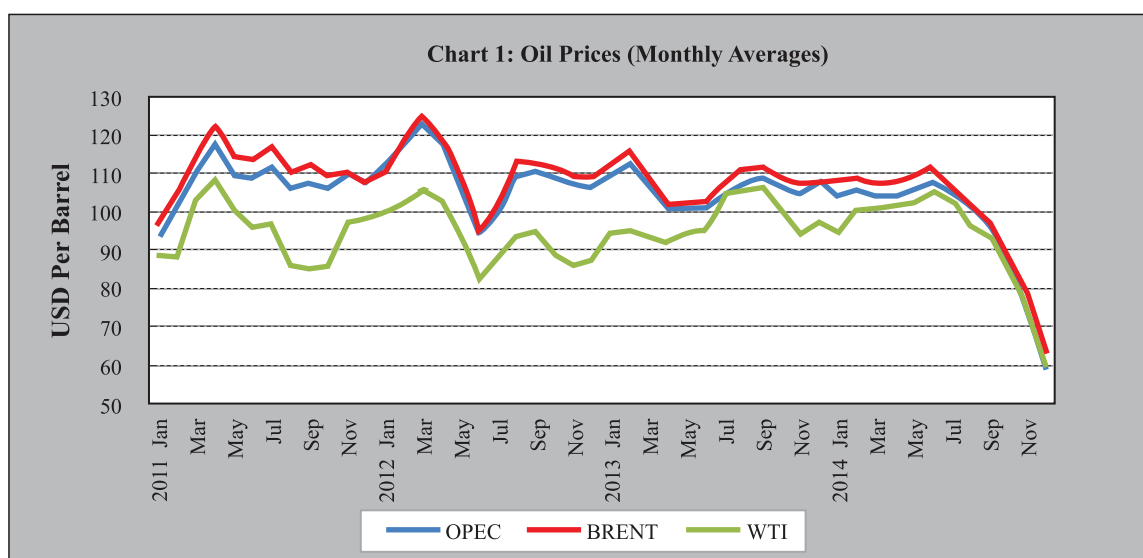
4 The real monetary conditions index (RMCI) measures the relative looseness or tightness of monetary conditions and gauges the likely effect that monetary policy has on the economy through changes in the exchange rate and interest rates. The real monetary conditions are measured by the RMCI that combines,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

- (e) *use of interest rates and open market operations to affect aggregate demand conditions in the economy and, ultimately, the rate of increase in prices⁵; in general, the Bank responds to a sustained deviation of inflation from the objective range, when the causal factors could be influenced by domestic monetary policy; and*
- (f) *monitoring of exchange rate developments and implementation of the crawling band exchange rate policy to support competitiveness of local producers.*

3. **IMPLEMENTATION OF MONETARY POLICY AND RELATED ECONOMIC DEVELOPMENTS IN 2014**

(a) **External Developments**

- 3.1 *Globally, monetary policy was conducted in the context of improving demand, modest economic activity, easing financing conditions, benign inflationary pressures and declining commodity prices, particularly oil price which fell significantly from mid-year. Monetary policy was largely accommodative through maintenance of low policy interest rates and continued liquidity support to the financial sector. Economic activity also benefited from the scaling down of austerity programmes in some developed economies. Meanwhile, policy response was mixed in emerging market economies as central banks either reduced interest rates to promote growth or tightened monetary policy to forestall inflationary pressures.*
- 3.2 *Economic performance strengthened in the USA and UK, as underpinned by improvements in labour market conditions and demand, while growth was subdued in the euro area and Japan. In emerging market economies, output growth was*

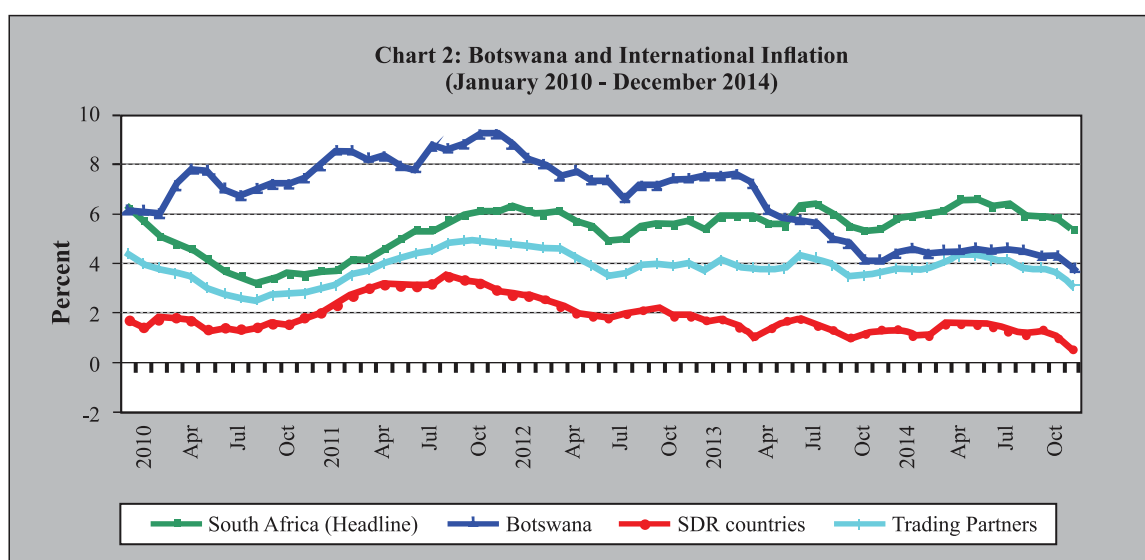


Source: www.opec.org and www.eia.gov.

5 *For example, a sustained level of economic performance above trend is potentially inflationary and could signal the need to increase interest rates to dampen inflationary pressures, while output below trend could require a reduction of interest rates to stimulate economic activity.*

generally more robust, although also weakening in some cases due to faltering domestic demand and the negative impact of falling prices of commodity exports. Overall, global output growth is estimated at 3.3 percent in 2014, which is the same as in 2013. The modest growth and persistent spare capacity in major economies, together with the fall in commodity (including oil, Chart 1) and food prices⁶ resulted in relatively low inflation, which eased slightly from 3.9 percent in 2013 to 3.8 percent in 2014.

- 3.3 For Botswana's trading partner countries, the trade-weighted average inflation fell from 3.6 percent in December 2013 to 3.1 percent in December 2014.⁷ Inflation for SDR countries decreased from 1.3 percent in December 2013 to 0.5 percent in December 2014⁸, while South Africa's inflation eased from 5.4 percent to 5.3 percent in the same period (Chart 2).⁹



Source: Statistics Botswana

(b) Monetary Policy Implementation in Botswana

- 3.4 Monetary policy was implemented in the context of below-trend economic growth (non-inflationary output gap) and a medium-term positive outlook for inflation. The Bank Rate was maintained at 7.5 percent throughout the year, and commercial banks' prime lending rate also remaining at 9 percent in the same period (Chart 3). Deposit interest rates edged up slightly, thus reflecting the tighter liquidity situation

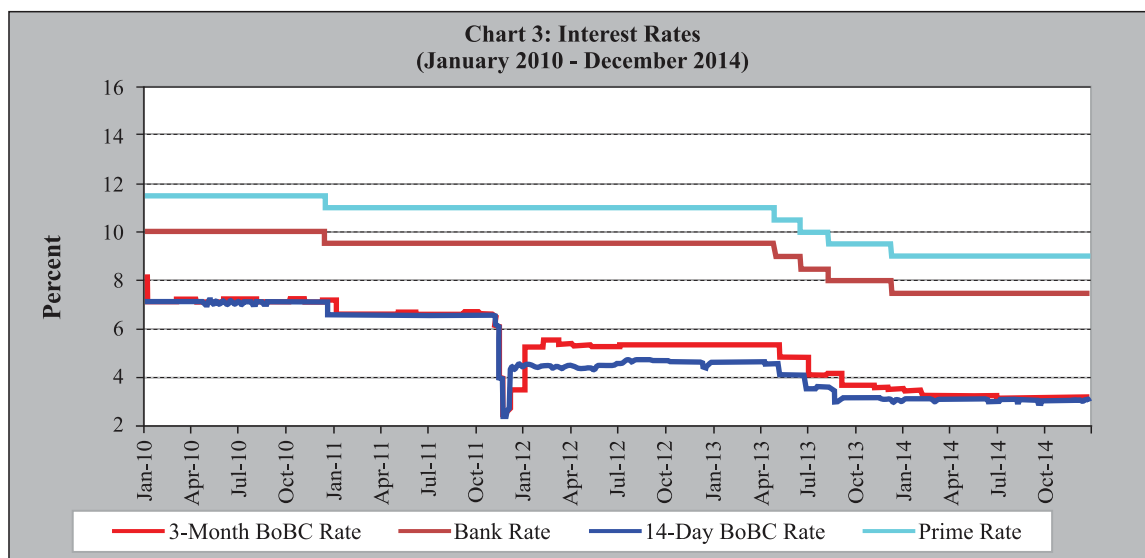
6 Food and Agriculture Organisation's food price index.

7 The trade-weighted average inflation comprises South Africa's headline inflation and SDR countries' inflation.

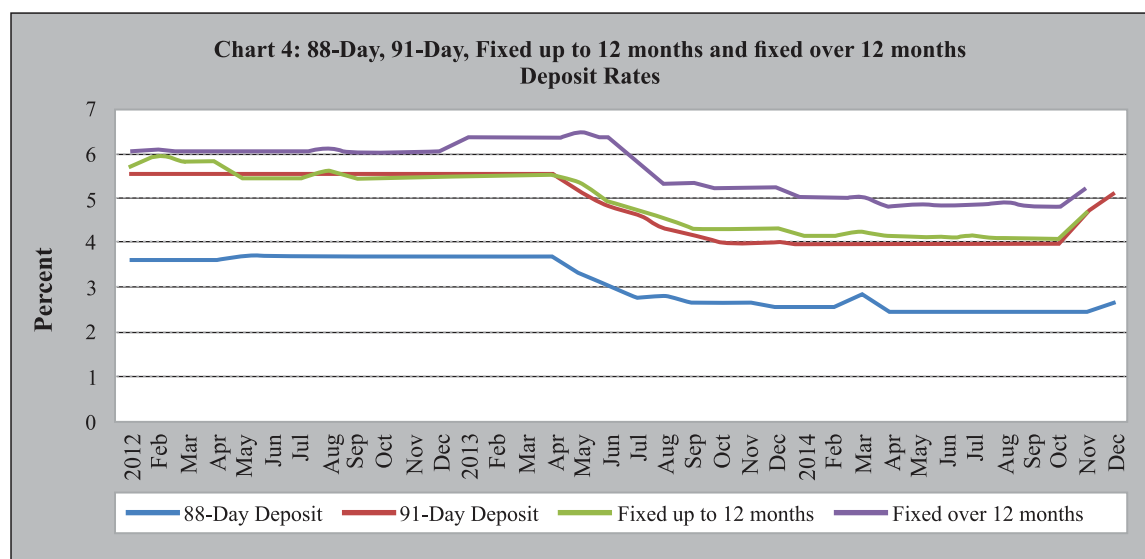
8 Inflation was below target and on a downward trend in the UK, USA and the euro area (where concerns about deflation emerged).

9 Inflation was above the country's medium-term target range of 3 – 6 percent in the period April - August 2014, with a peak of 6.6 percent in May and June.

at commercial banks (Chart 4). In an effort to encourage and reward depositors, commercial banks are required to offer and publish a 91-day deposit or equivalent deposit product which pays an interest rate that, at a minimum, is 3.5 percentage points below the prevailing Bank Rate¹⁰, with longer-dated deposits expected to earn commensurately higher interest rates. Bond yields range from 3.9 percent to 6.3 percent for the shortest and longest maturities, respectively.



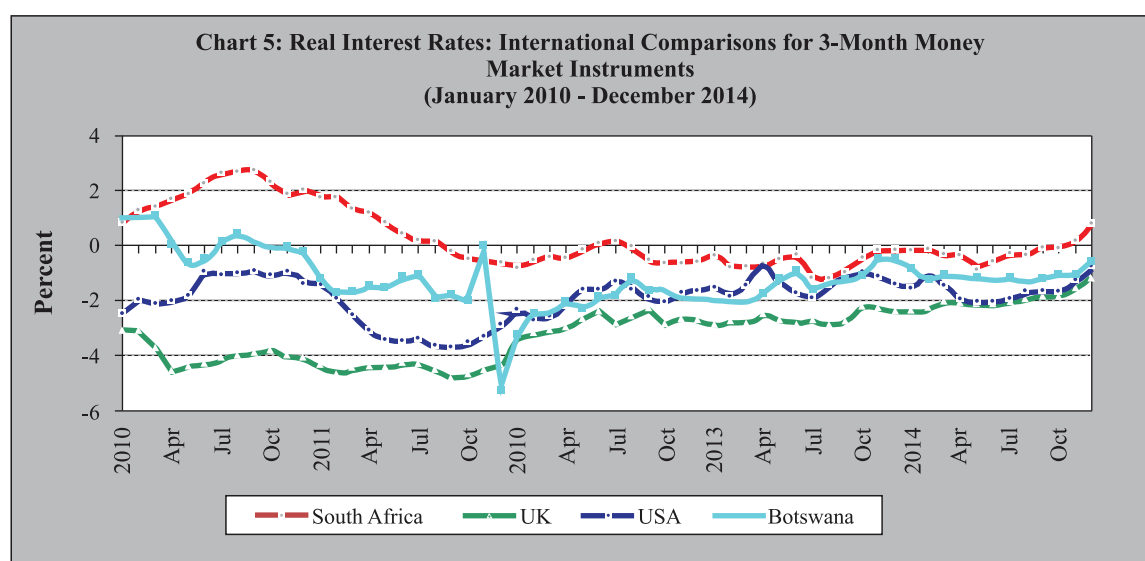
Source: Bank of Botswana



Source: Commercial banks

¹⁰ Given the Bank Rate of 7.5 percent, the minimum deposit interest rate is 4 percent for the 91-day deposit product.

- 3.5 *Monetary policy implementation involved the use of Bank of Botswana Certificates (BoBCs) to absorb excess liquidity in order to ensure maintenance of interest rates that are consistent with the monetary policy stance; while reverse repurchase agreements were used to mop up liquidity between auctions of BoBCs. Excess liquidity has decreased in recent years, and this reflects a number of factors, among which were the rapid growth in the intermediation ratio (as credit increased much faster than deposits), externalisation of funds by institutional investors and initiatives by the Government to rationalise disbursement of funds to parastatals and local authorities. Temporary liquidity shortfalls experienced by individual financial institutions continued to be addressed through access to the interbank market and recourse to the Bank's credit facilities. In order to encourage productive deployment of funds and market efficiency, the Bank conducted monetary operations with a reduced amount of excess liquidity available for auctioning BoBCs. Thus, the value of outstanding BoBCs fell from P5.5 billion in December 2013 to P4.2 billion in December 2014.*
- 3.6 *The 14-day BoBC yield remained unchanged at 3.1 percent from December 2013 to December 2014, while the 3-month BoBC yield decreased from 3.6 percent to 3.2 percent in the same period. The faster decrease in the nominal 3-month BoBC yield than the fall in inflation between December 2013 and December 2014 resulted in a marginal decline in the real interest rate (Chart 5).¹¹*



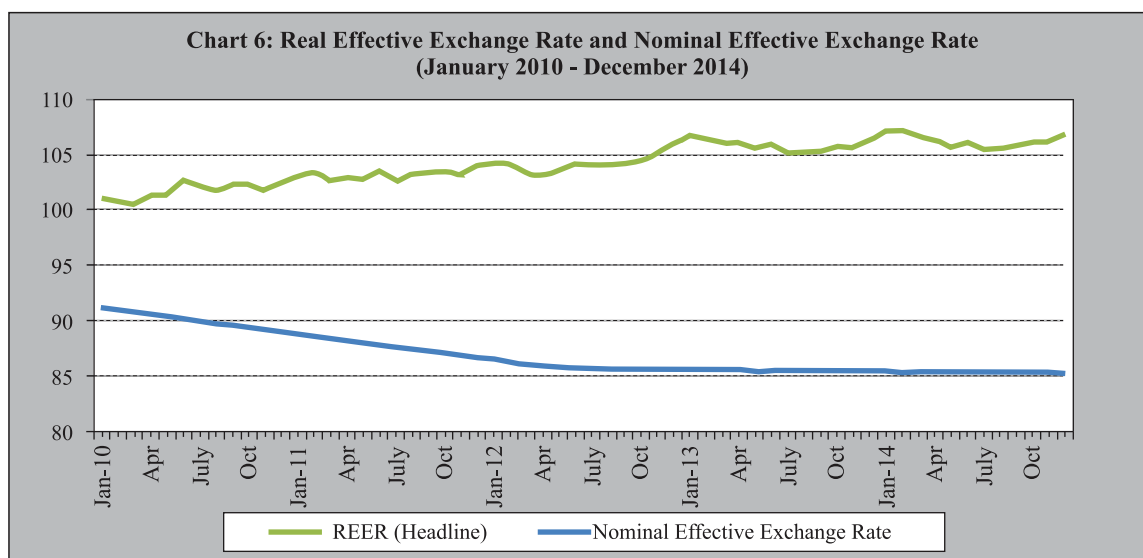
Source: Bank of Botswana

(c) **Implementation of Exchange Rate Policy**

- 3.7 *In line with the policy objective of maintaining a stable real effective exchange rate (REER) of the Pula, the Bank implemented a modest downward crawl of the Pula exchange rate (minus 0.16 percent per annum). Consequently, in 2014, the NEER of*

¹¹ *The real 14-day BoBC rate rose from -1 percent in December 2013 to -0.7 percent in December 2014. In comparison, real 3-month money market interest rates were -0.6 percent, 0.8 percent, 0.1 percent, -0.8 percent and 0 percent in December 2014 for Botswana (3-month BoBCs), South Africa, UK, USA and the euro area, respectively.*

the Pula depreciated by the same magnitude against the trade-weighted average of trading partner country currencies in the year to December 2014. The downward crawl, and the related depreciation of the NEER, was smaller than the differential between inflation in Botswana and the average inflation of trading partner countries, thus resulting in a modest 0.4 percent appreciation of the REER in the year to December 2014 (Chart 6).



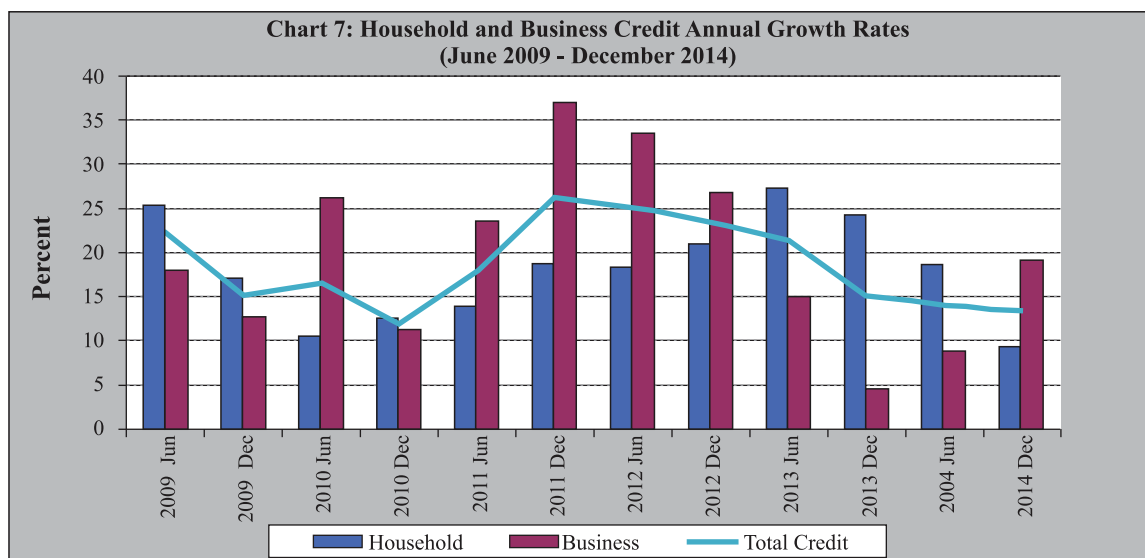
Source: Bank of Botswana

(d) Government Expenditure and Credit Growth

3.8 Monetary policy was conducted in the context of the 14 percent annual growth in government expenditure (twelve months to December 2014), which supported domestic economic activity. Development¹² and Recurrent expenditure rose by 25.7 percent and 10.9 percent, respectively, in the same period. The increase in Recurrent expenditure included a modest 4 percent increase in salaries for civil servants, with a small impact on aggregate demand. There were no changes to the tax regime except for the 5 percentage point increase in the alcohol levy to 55 percent. Despite maintenance of an accommodative monetary policy, credit growth was lower in 2014, at 13.5 percent compared to 15.1 percent in 2013, mostly reflecting a much slower rate of increase in lending to households. Annual growth in credit to the household sector decelerated from 24.2 percent in 2013 to 9.4 percent in 2014 (Chart 7). This development reflected the significant slowing in the yearly increase in mortgages from 40.1 percent to 18.4 percent and in personal loans from 19.6 percent to 5.3 percent, in an environment of slow growth in incomes. At the same time, there was weak growth in loanable funds, which also further suppressed credit growth through tighter lending conditions.¹³

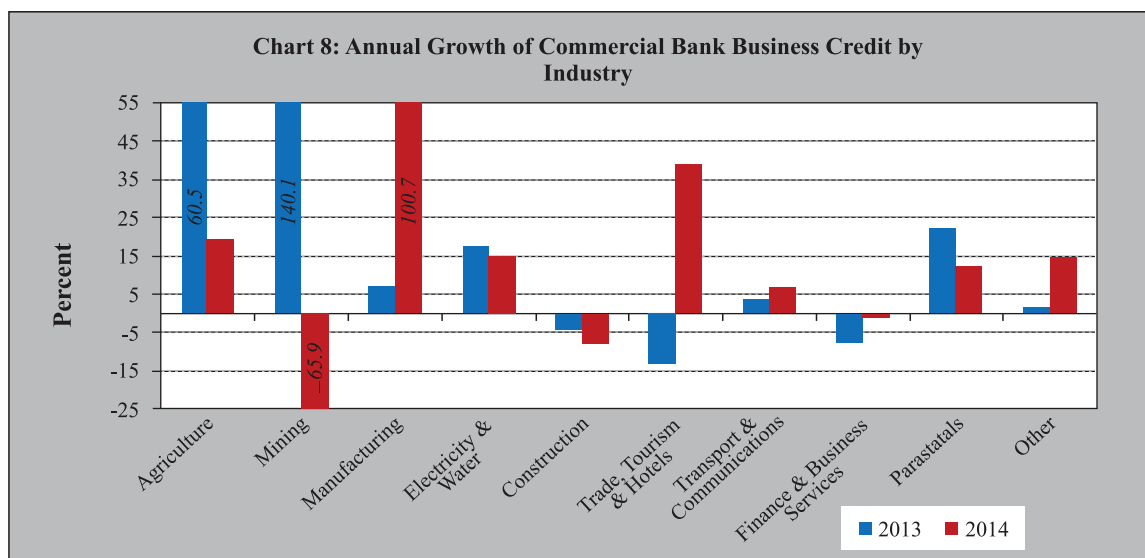
¹² The rapid acceleration in development spending is largely due to the drawdown of P1.5 billion from funds allocated to provide emergency financing to the Botswana Power Corporation.

¹³ These trends in household and business credit may be exaggerated by banks' reclassification of significant amounts of loans between the two categories, without necessarily correcting data for the earlier periods.

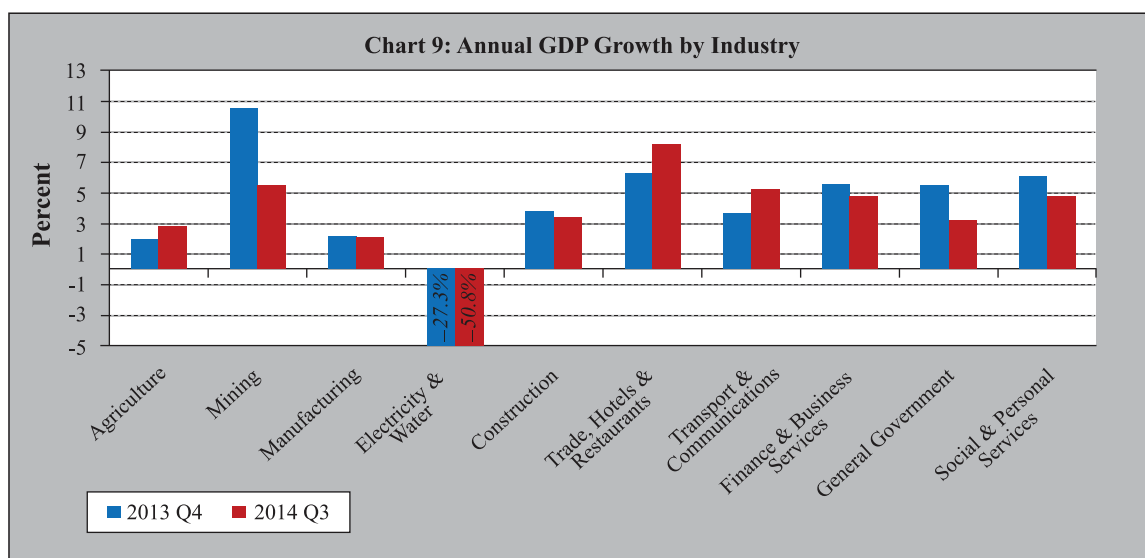


Source: Commercial Banks

- 3.9 *The slowdown in the growth of mortgage lending appears to be consistent with other indications that the market for residential property is weakening, especially for high-value properties. The slowdown in growth of mortgages followed a period of rapid growth and could be indicative of portfolio rebalancing and debt consolidation. Mortgage lending by the Botswana Building Society grew by 19.6 percent in 2014, while there has been a notable growth in the share of mortgages in total bank household credit, from 25.1 percent in December 2010 to 30.6 percent in December 2014.*
- 3.10 *In contrast, there was a significant increase in annual credit expansion to businesses from 4.6 percent in 2013 to 19.1 percent in 2014. The acceleration in business credit growth was mainly driven by the manufacturing and trade, tourism and hotels sectors, while other sectors of the economy had a lower impact (Charts 8 and 9).*



Source: Commercial banks

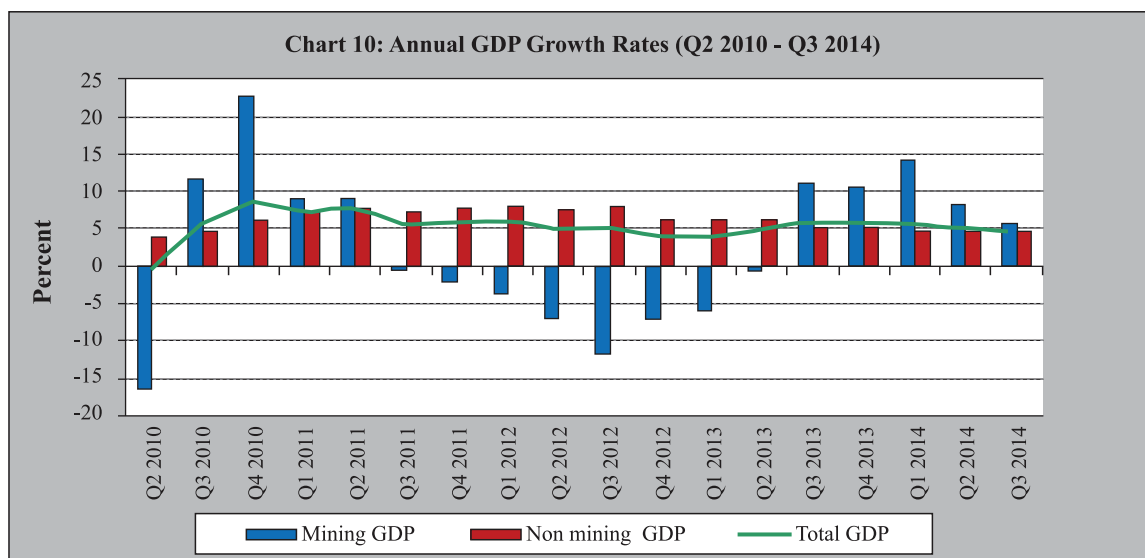


Source: Statistics Botswana and Bank of Botswana calculations

Note: The growth rate is calculated as the percentage change in cumulative GDP over four quarters compared to the corresponding period ending in the previous year.

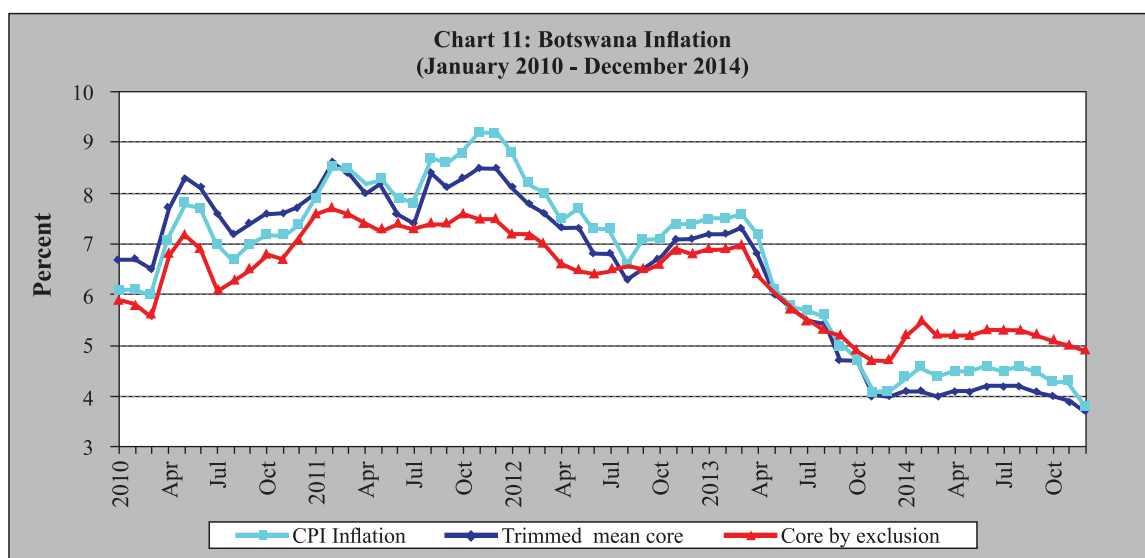
(e) Output and Price Developments

3.11 Annual growth in non-mining GDP slowed to 4.7 percent in the twelve months to September 2014, compared to 5.2 percent in the corresponding period in 2013. Mining output increased by 5.5 percent; it expanded by 11 percent a year earlier (2013). As a result, overall real GDP growth slowed from 6 percent in the year to September 2013 to 4.8 percent in September 2014 (Chart 10).

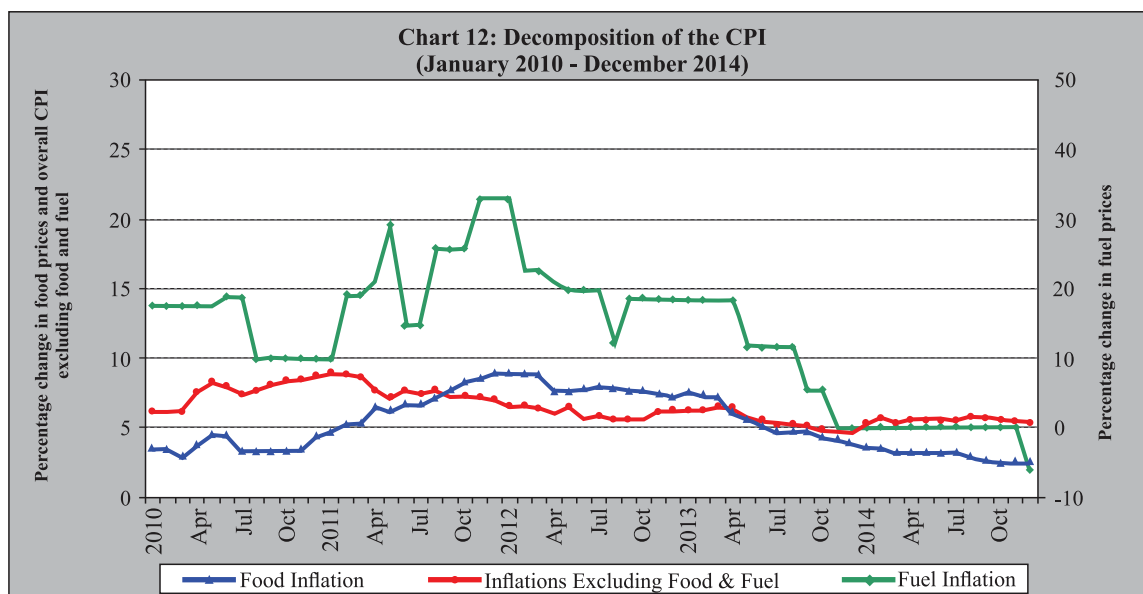


Source: Statistics Botswana and Bank of Botswana calculations

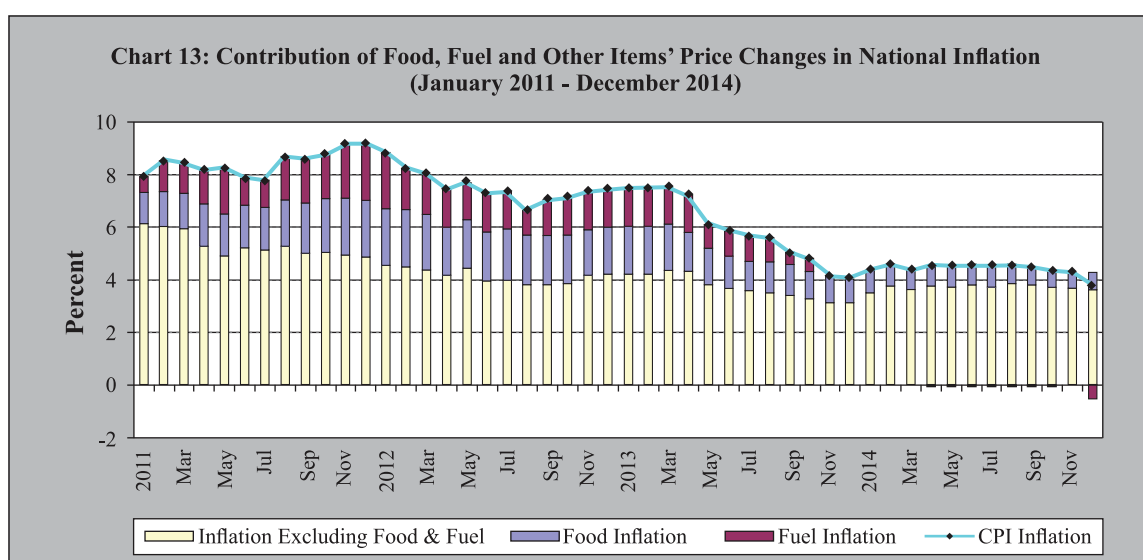
3.12 The policy stance and changes in monetary indicators, as well as external developments, contributed to dampened inflationary pressures during 2014. Thus, inflation fell from 4.1 percent in December 2013 to 3.8 percent in December 2014 (Chart 11) against the background of modest wage growth, weak demand pressures and the subdued impact of the increase in administered prices and government levies. External pressures on domestic prices were also benign in the context of low and declining trading partner countries' inflation and a favourable rand/Pula exchange rate. The decrease in inflation is reflected across most categories of goods and services. In particular, food price inflation eased from 3.9 percent in December 2013 to 2.5 percent in December 2014, while fuel prices decreased by 6.1 percent in the same period (Charts 12 and 13).



Source: Statistics Botswana



Source: Statistics Botswana



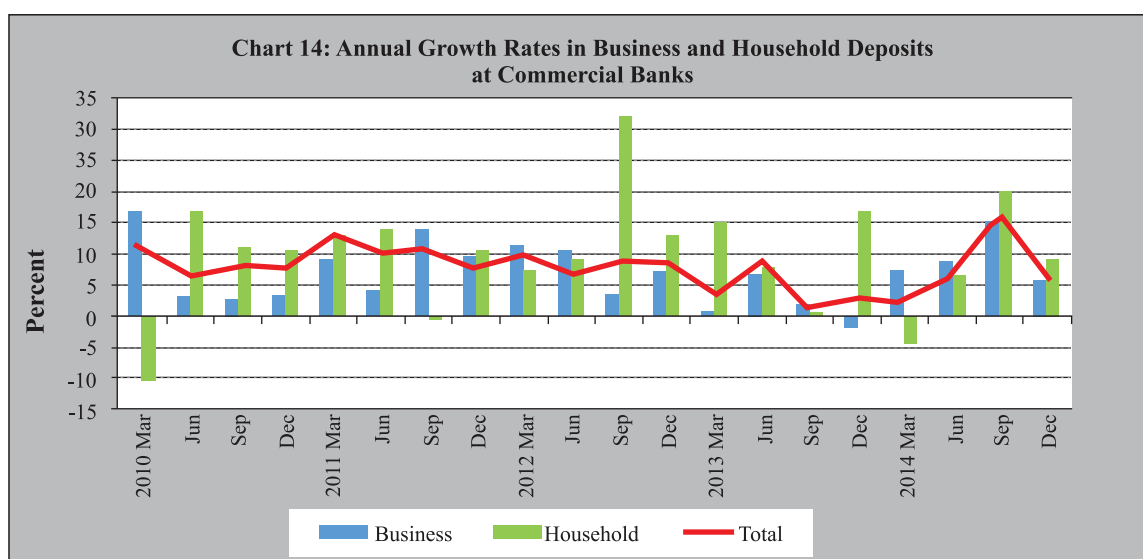
Source: Statistics Botswana

3.13 Domestic inflation fluctuated in 2014 and peaked at 4.6 percent in February 2014 due to the impact of the upward adjustment of the alcohol levy as well as higher costs of health and education. The subsequent decline in inflation was due to a general moderation of the pace of price increases, which included the reduction in fuel prices and dissipation of the effect of the previous year's increase in the alcohol levy. On average, the net effect of adjustments of administered prices was a reduction in inflation by approximately 0.39 percentage points in 2014 compared to an increase of 0.34 percentage points a year earlier. Inflation excluding administered prices increased from 4.7 percent in December 2013 to 4.9 percent in December 2014, while the 16 percent trimmed mean inflation decreased from 4 percent to 3.7 percent in the same period.

(f) Financial Stability Indicators

- 3.14 *The deceleration in the rate of growth in household credit represents a normalisation in line with the slower growth in incomes, which augurs well for maintenance of financial stability. Similarly, the softening of mortgage credit against the background of moderation in the property market reduces potential risks in this area. Thus, current indicators of low and stable default ratios for household borrowing reflect a generally stable financial system. The ratio of non-performing loans to total credit was 2.9 percent at the end of December 2014 in the context of a well-capitalised banking system and sufficient provisioning by banks. Moreover, prospects for sustained positive economic growth imply a possible increase in incomes and demand to support a sound financial system.*
- 3.15 *Household loans continue to dominate commercial bank credit at 56 percent of all loans (end - 2014). While there may be concerns about the productivity of such lending, the risk to financial stability is moderated by the extent to which such credit is diversified; it is characterised by relatively small amounts to a wide range of clients spread across several sectors. Moreover, availability of security in terms of collateral and insurance, and access to credit on the basis of wage income (where the risk of loss of employment is low), contribute to lower credit risk. Business credit is also diversified across growing economic sectors.*
- 3.16 *With respect to deposits, the largely undiversified funding of banks by bulky business deposits (71 percent of total deposits), part of which are for other financial institutions, reflects a possible imbalance in the market. Moreover, deposits at commercial banks grew by 6.1 percent in December 2014, compared to 2.7 percent in 2013 (Chart 14). This growth resulted from the annual increase in business deposits moving from a contraction of 2 percent to a growth of 5.8 percent in the same period, while household deposits growth slowed from 16.7 percent to 9.2 percent. In the context of the increase in deposits being less than growth in bank lending, the intermediation ratio increased from 82 percent in December 2013 to 88 percent in December 2014.¹⁴*

14 *The intermediation ratio is defined as the ratio of total loans to total deposits.*



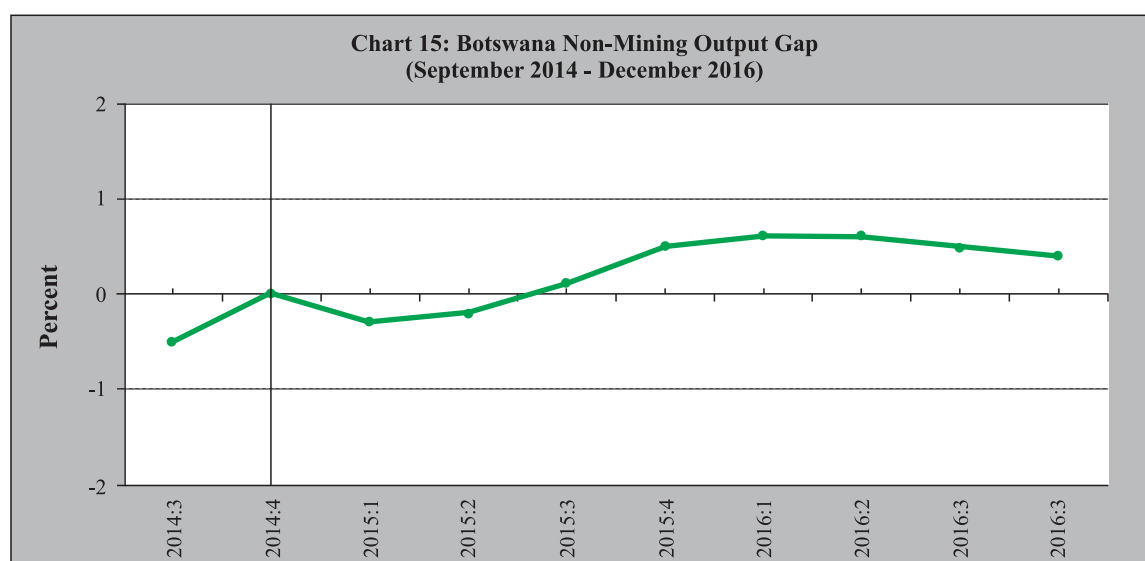
Source: Commercial banks

4. INFLATION OUTLOOK

4.1 Global output growth is forecast at 3.5 percent (revised from 3.8 percent) in 2015, slightly higher than the estimated 3.3 percent for 2014. The projected faster increase in the global economic activity in 2015 is predicated on some pick-up in advanced economies, led by the USA, while a moderation in growth is anticipated for emerging market economies. Growth will be supported by key factors in advanced countries, including unwinding fiscal consolidation and maintenance of accommodative monetary policy as well as the introduction of an extensive programme of quantitative easing by the European Central Bank. It is expected that moderate economic growth in emerging market economies will benefit, in some cases, from removal of structural impediments and strengthening demand. Geopolitical tensions will continue to present downside risks to economic performance for both developed and developing economies.

4.2 It is anticipated that inflationary pressures will be restrained in the context of weaker commodity prices and modest world economic activity. As such, global inflation is forecast to increase slightly from 3.8 percent in 2014 to 3.9 percent in 2015. Inflation remains low in most advanced economies, while deflation continues to be a concern in the euro area and Japan. Emerging market economies' inflation is expected to be higher in 2015, but will be restrained by weakening commodity prices particularly for food (which has a large weight in the consumer price index). Against this background, it is anticipated that monetary policy will remain accommodative in the major economies, against the background of liquidity support as complemented by measures aimed at promoting financial intermediation and fostering resilience of the financial sector to bolster economic activity.

- 4.3 For SDR countries, inflation is forecast to be 1.3 percent in 2015, the same as in 2014. In South Africa, headline inflation is projected to decrease from an average of 6.1 percent in 2014 to 5.5 percent in 2015¹⁵; thus, average inflation for trading partner countries is forecast to be in the range of 3 – 4 percent. Given that Botswana's inflation is projected to be close to the lower bound of the medium-term objective range of 3 – 6 percent, the NEER will be constant (zero rate of crawl) in 2015. The Pula basket weights have changed from 55 percent South African rand and 45 percent SDR to equal proportions of 50 percent. Therefore, it is anticipated that the influence of external price developments through imported inflation and changes in the exchange rate on domestic inflation will be modest.
- 4.4 Domestic output expansion is forecast to be 4.9 percent in 2015, lower than the revised estimate of 5.2 percent for 2014. However, non-mining output growth is expected to be above trend in the medium term (Chart 15). The results of the Business Expectations Survey (BES) conducted by the Bank in September 2014 show some modest expectations of improvement in economic prospects in 2015, with export-oriented businesses more confident than domestic-oriented businesses. Nonetheless, the ongoing challenges relating to power supply and water shortages could dampen economic activity.



Source: Bank of Botswana

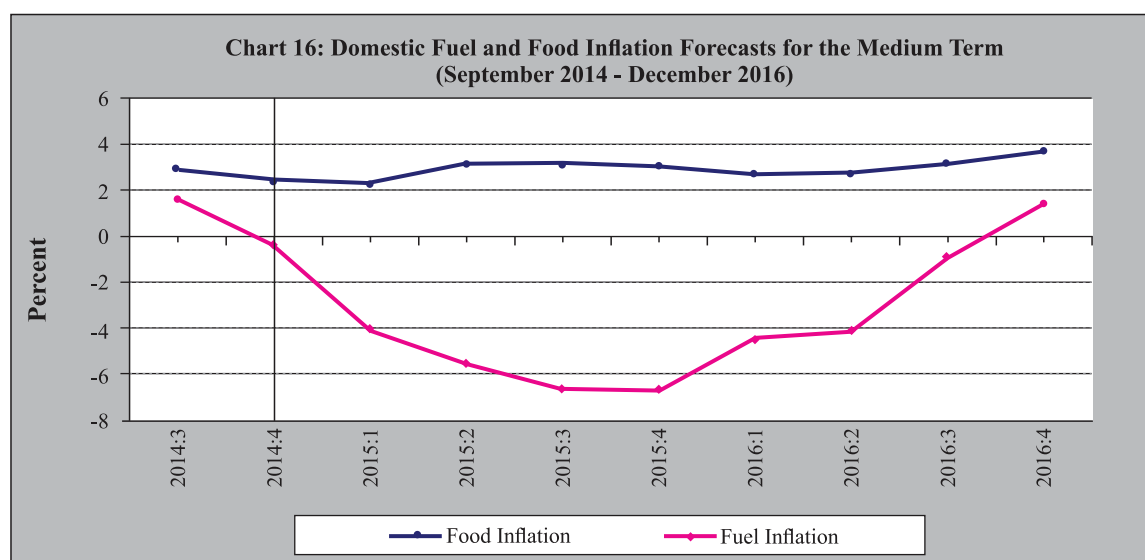
- 4.5 For the 2015/16 fiscal year, total government expenditure is estimated to increase by 5.6 percent, with an overall budget surplus of P1.2 billion. Recurrent and Development expenditure votes are projected to increase by 9.1 percent and contract by 4 percent, respectively, in the same period. The amendments of the Value Added Tax Act that came into effect at the beginning of 2015 extended the range of goods that are zero rated to include additional staple foodstuff.¹⁶ This provides some

¹⁵ The forecasts are sourced from Thompson Reuters. The South African Reserve Bank's inflation forecast for 2015 is lower at 3.8 percent.

¹⁶ These include unprocessed fruit and vegetables, cereals not already covered (rice and samp), milk, bread flour and brown bread.

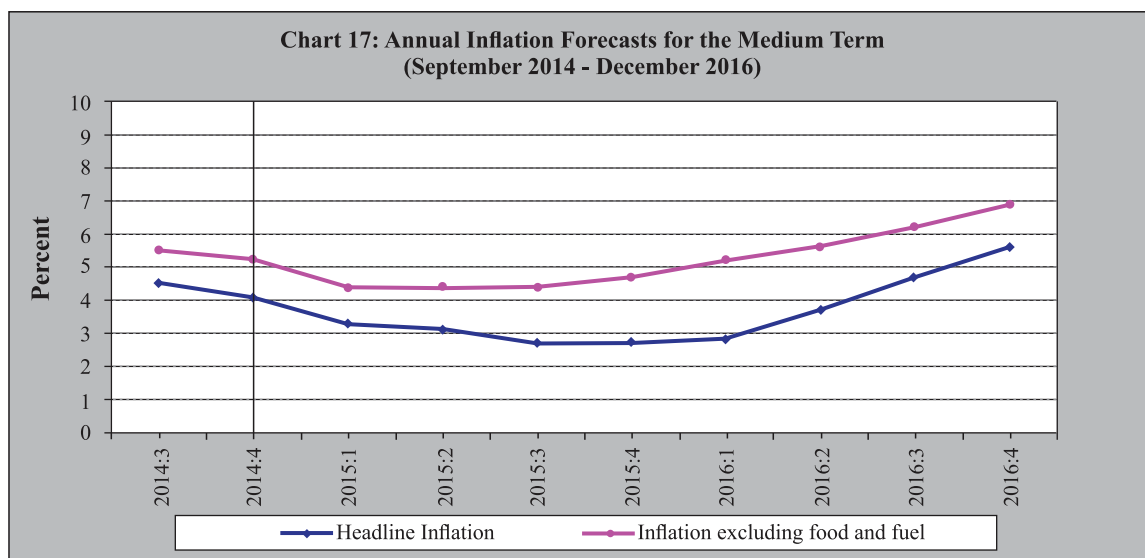
potential for lower prices (to a maximum of 12 percent) for these items, which comprise approximately 5 percent of the CPI basket; in turn, this would lead to some short-term reduction in headline inflation. In principle, this decrease in inflation could amount to as much as 0.6 percentage points. However, the administrative costs of these changes could erode the magnitude and timing of price cuts. On the other hand, the resultant savings on food spending could boost domestic demand in other expenditure categories. Meanwhile, it is anticipated that the 5 percentage point increase in the alcohol levy (to 55 percent) will add 0.3 percentage points to inflation in 2015, while the decrease in fuel prices in February 2015 is expected to reduce inflation by 0.93 percentage points.

- 4.6 It is anticipated that domestic demand pressures on inflation will be modest, thus reflecting restrained growth in personal incomes. As indicated in the 2015 Budget Speech, any increase in salaries for public servants is likely to be modest and, therefore, not generate significant demand and expectations-related inflationary pressures. Given prospects for benign external price developments, it is projected that inflation will continue to be within the 3 – 6 percent medium-term objective range, with the possibility of a breach of the lower bound in the short term (Chart 17). Any substantial upward adjustment in administered prices and government levies beyond current projections (Chart 16) present upside risks to the inflation outlook. Nevertheless, there are downside risks arising from weaker global economic activity, falling commodity prices, technological progress, productivity improvements, structural reforms, growing trade and competition that could result in lower inflation than currently projected.¹⁷



Source: Bank of Botswana

¹⁷ The September 2014 BES indicates expectations of inflation of 6.1 percent, which is significantly higher than current and projected levels.



Source: Bank of Botswana

5. 2015 MONETARY POLICY STANCE

- 5.1 *An assessment of determinants of inflation and financial stability suggests continuation of low-to-moderate inflation into the medium term, within a sound and supportive financial environment. Notably, credit growth is deemed to be supportive of economic activity; and, consistent with the slower rate of increase in incomes and bank funding, it has been declining, especially for households. Thus, both business and household credit are assessed to be at sustainable levels and not deemed to pose a threat to financial stability.*
- 5.2 *Therefore, the current and prospective developments (positive outlook for inflation and a stable financial environment) augur well for accommodative monetary policy in the best interest of productive lending to businesses and households.*
- 5.3 *In 2015, the Bank's implementation of the exchange rate policy will entail a zero rate of crawl for the NEER, given that inflation is projected to be close to the lower bound of the medium-term objective range of 3 – 6 percent. The crawling band exchange rate policy is in the best interest of international competitiveness of domestic industries and contributes towards macroeconomic stability and economic diversification.*

6. CONCLUSION

- 6.1 *Given the modest demand and absence of upward pressures of administered prices, domestic inflation remained within the Bank's objective range of 3 – 6 percent in 2014. Global GDP growth is projected to be marginally higher in 2015 compared to 2014, thus reflecting continued global challenges. Global inflation is forecast to increase slightly from 3.8 percent in 2014 to 3.9 percent in 2015. It is expected that lower energy prices, persistent spare capacity in advanced countries and modest demand will restrain inflationary pressures.*

- 6.2 *Domestic inflation is forecast to remain within the Bank's objective range of 3 – 6 percent in the medium term, with the possibility of breaching the lower end in the short term. The Bank's formulation and implementation of monetary policy will focus on entrenching expectations of low and sustainable inflation in the medium term, through timely responses to price developments, while ensuring that credit and other market developments are consistent with lasting stability of the financial system. The Bank remains committed to responding appropriately to all economic and financial developments with a view to ensuring price and financial stability, in the best interest of sustainable economic growth.*