MID-TERM REVIEW OF 2007 MONETARY POLICY STATEMENT

1. Introduction

1.1 There are three objectives to undertaking the mid-term review (MTR) of the Monetary Policy Statement (MPS). First, the MTR is intended to assess progress in attaining the 2007 inflation objective as contained in the MPS; second, it considers the financial and economic outlook for the latter half of the year, and evaluates the need to change the current monetary policy stance; and third, it apprises stakeholders of the key issues that are likely to influence policy formulation in the remainder of 2007, in order to affect the formation of expectations about inflation.

1.2 At the beginning of 2007, the Bank set the annual inflation objective of 4 – 7 percent for the year in consideration of, among others, forecast inflation in trading partner countries of 4 – 6 percent. This suggests lowering the upper end of the inflation objective in order to meet the related objective of a stable and competitive real effective exchange rate (REER), in the absence of a nominal effective exchange rate (NEER) adjustment. However, the outlook for domestic inflation was that it would remain higher than inflation in trading partner countries. In order to achieve the inflation objective gradually, the Bank set the 2007 inflation objective to accommodate some of the transitory higher level of inflation in the short-term. In the circumstances, a modest downward crawl of the exchange rate would contribute to achieving REER stability. The Bank's commitment to long-term price stability was indicated by the adoption in 2006 of the three-year medium-term inflation objective of 3 – 6 percent. The measured approach to reducing inflation recognises the short-term upward pressures on inflation due to transitory factors. It is also expected that policy success in influencing expectations and in achieving market related pricing by parastatals, as well as productivity improvements, would, in the long-term, result in sustainable low inflation.

1.3 In controlling inflation, the Bank uses interest rates and open market operations to influence changes in aggregate domestic demand by focusing primarily on growth of commercial bank credit, as an intermediate target, given that it contributes significantly to demand pressures and can be influenced by monetary policy. The Bank also monitors the likely impact on price developments emanating from growth in government spending as it is a major component of consumption and investment expenditure. In this regard, the Bank has a view as to the growth rate of government spending that is consistent with the inflation objective. Monetary policy also responds to and seeks to influence the formation of public expectations of inflation, as reflected by price and wage adjustments that are in line with the Bank's inflation objective, particularly in the context of transitory shocks such as increases in administered prices. The Bank, therefore, remains committed to responding appropriately to any inflationary effects of fiscal measures and expectations.

2. Inflation trends in the first half of 2007

2.1 Inflation fell in the first half of the year from 8.5 percent in December 2006 to 6.4 percent in June 2007 and was within the Bank's annual objective from March to June 2007 (Chart 1). The lower level of inflation in the first half of 2007 reflects the impact of monetary policy on price developments in the absence of supply-side and transitory shocks, such as the devaluation of the Pula and increase in administered prices, which were major influences on inflation from the second half of 2005. In the first half of 2007, it is estimated that the May 2007 increase in fuel prices initially contributed 0.4 percentage points directly to inflation in the second quarter.

2.2 The Central Statistics Office commenced the publication of two core inflation measures, along with the headline rate of inflation, in the first half of 2007. The first measure, which is the 16 percent trimmed-mean, excludes 8 percent (by weight) of the most extreme movements (compared to the average) from either end of an ordered series of price changes of goods and services, in any given month. The other core inflation measure excludes price changes for administered price items listed in the Appendix; hence this measure of inflation removes the volatility inherent in administered prices, which are invariably only adjusted periodically and not necessarily in response to prevailing market forces.

2.3 The core inflation as measured by the 16 percent trimmed-mean method fell from 7.6 percent in December 2006 to 6.1 percent in June 2007, while inflation excluding administered prices was 6.8 percent in June 2007.[1]

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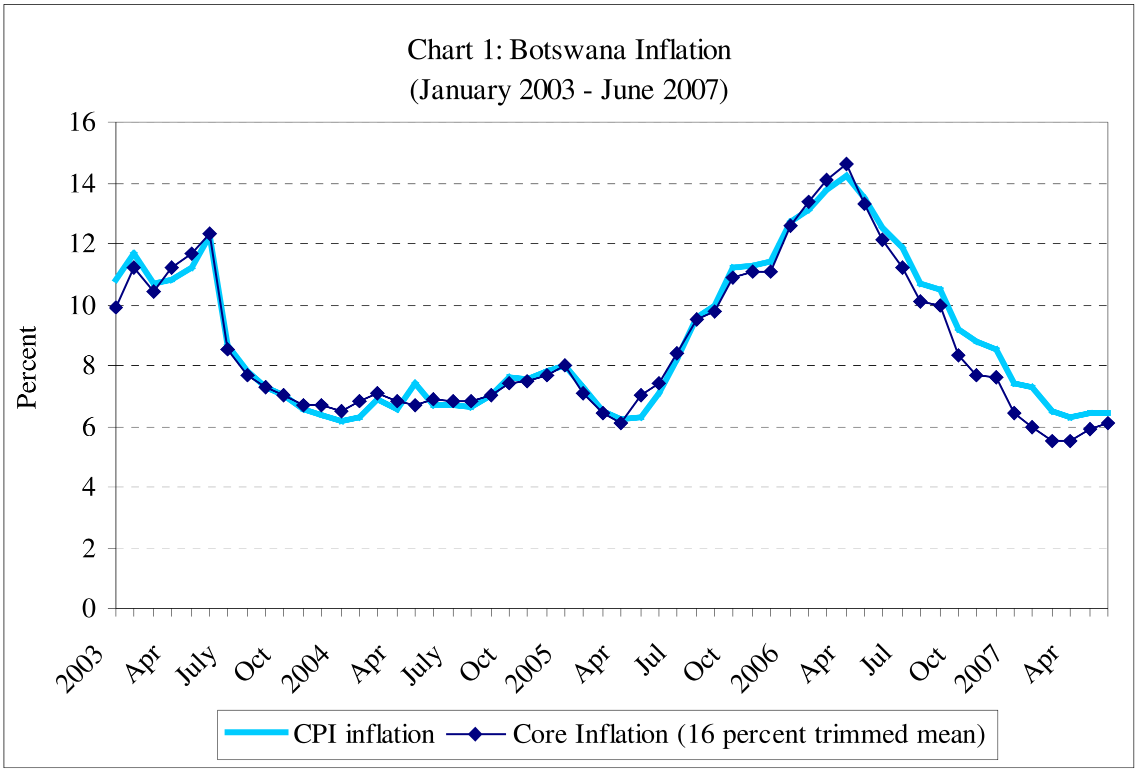
1 *While the 16 percent trimmed-mean measure of inflation has been used internally by the Bank for some time, the core inflation by exclusion of administered prices was published for the first time this year.*



2.4 *Domestic tradeables inflation rose from 10.3 percent in December 2006 to 12.2 percent in June 2007, while inflation for imported tradeables fell from 7 percent to 4.7 percent over the same period, thus resulting in the annual rise in the cost of all-tradeables falling from 8 percent to 7.2 percent over the same period. For non-tradeables, the yearly increase in cost decreased from 9.5 percent in December 2006 to 4.7 percent in June 2007 as the impact of the January 2006 re-introduction of school fees in public secondary schools dropped out of the inflation calculation.*

2.5 *Demand pressures on inflation were moderate in the first half of the year with a modest decrease in annual credit expansion, from 18.8 percent in December 2006 to 17.5 percent in June 2007 (Chart 3). Since October 2006, the annual growth of credit has remained above the Bank's desired range of 11 – 14 percent, which is considered to be consistent with the Bank's annual inflation objective. The faster credit expansion is underpinned by a positive economic outlook engendered by the February 2007/08 Budget, which included a projected 18 percent growth in government expenditure. However, the impact of these factors on domestic demand pressures has so far been mitigated by persistent under-spending of the budget emanating from implementation constraints, as well as a restrictive monetary policy.*

2.6 *In the February 2007 Budget Speech, total government recurrent and development expenditure for 2006/07 was projected to be 25.2 percent higher* *than spending in 2005/06. However, the actual outcome shows a much lower government expenditure growth of 10.6 percent for the 12 months to March 2007 (Chart 3), and thus adding modestly to demand pressures. In the context of the impact of measures aimed at improving implementation, growth in government spending for the twelve months to June 2007 was much faster at 15.3 percent.*[2]

2.7 *External influences on domestic inflation were largely benign in an environment in which major economies maintained a restrictive monetary policy stance in order to curb inflationary pressures arising from high international oil prices. In particular, interest rates were raised twice in both the UK and euro area in the first half of 2007 by 25 basis points each time. In South Africa, the repo rate was increased by 50 basis points in June 2007, after four adjustments of the same magnitude were effected in 2006. Global inflation in the first half of 2007 was estimated at 2.3 percent, which was lower than the 3 percent of 2006, despite international oil prices rising from USD60 per barrel at the beginning of the year to USD72 per barrel in late June 2007. Meanwhile, productivity gains and an increase in world trade contributed to robust global output growth in the first half of 2007, mainly sustained by strong economic activity in China and India. World output growth*[3] *is estimated at around 3.4 percent in 2007, compared to 3.8 percent in 2006.*

2.8 *Average inflation for Botswana's trading partner countries*[4] *increased in the first half of 2007, from 4.3 percent in December 2006 to 5 percent in June 2007 (Chart 2), due to faster price changes in South Africa occasioned by the oil price increase and staple food shortages. South Africa's CPIX inflation*[5] *increased from 5 percent in December 2006 to 6.4 percent in June 2007, thus breaching the country's target range of 3 – 6 percent for the first time since August 2003. Average inflation for the SDR countries declined from 3 percent in December 2006 to 2.3 percent in June 2007.*

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2 *It should be noted, however, that the much faster growth in recurrent expenditure compared to development expenditure might be indicative of redressing a backlog on recurrent payments rather than significant improvements on implementation of development projects. Moreover, there is a significant amount of the increase that is due to grants and subventions for new autonomous government agencies.*

3 *The rates for global GDP growth and inflation differ from those reported in the Monetary Policy Statement (MPS) on account of different data sources, which use different weights (market exchange rates or purchasing power parity (PPP) exchange rates) to aggregate data across countries. Figures reported are from JP Morgan (where market rates are used to calculate global output growth), while those in the MPS are from the IMF (where PPP rates are used). The JP Morgan series is more appropriate for this review in terms of availability of quarterly data.*

4 *South Africa and the SDR countries (USA, Japan, UK and the euro zone).*

5 *The South African Reserve Bank's target measure of inflation, which excludes mortgage interest rates from the headline measure of inflation.*

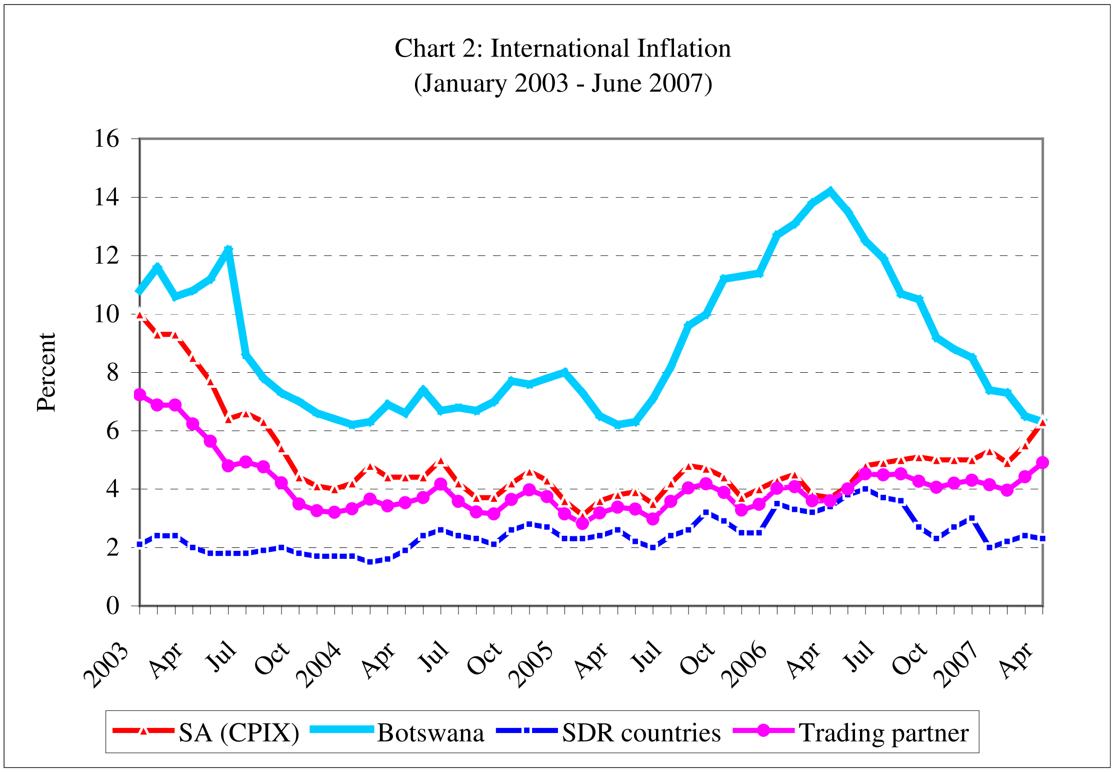


Chart 2: International Inflation
(January 2003 - June 2007)
16
14
12
10
8
6
4
2
0
Percent
2003
Apr
Jul
Oct
2004
Apr
Jul
Oct
2005
Apr
Jul
Oct
2006
Apr
Jul
Oct
2007
Apr
SA (CPIX)
Botswana
SDR countries
Trading partner

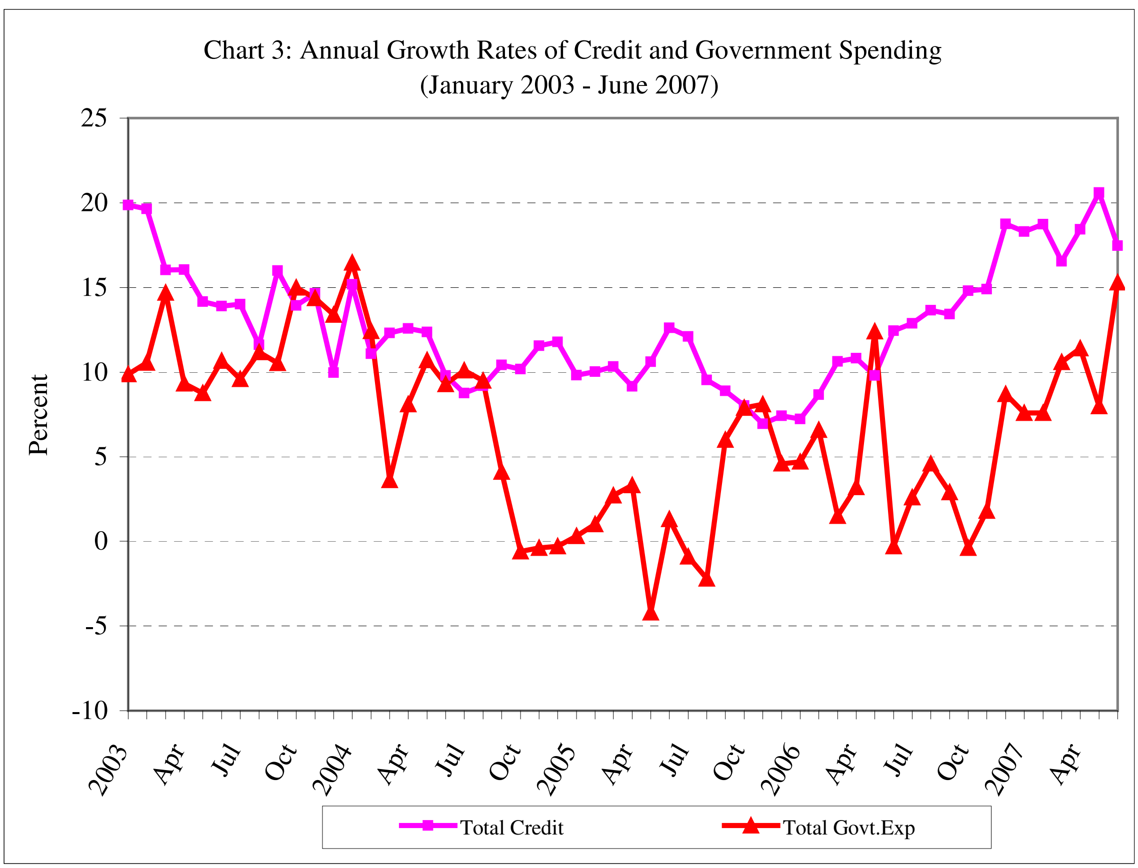
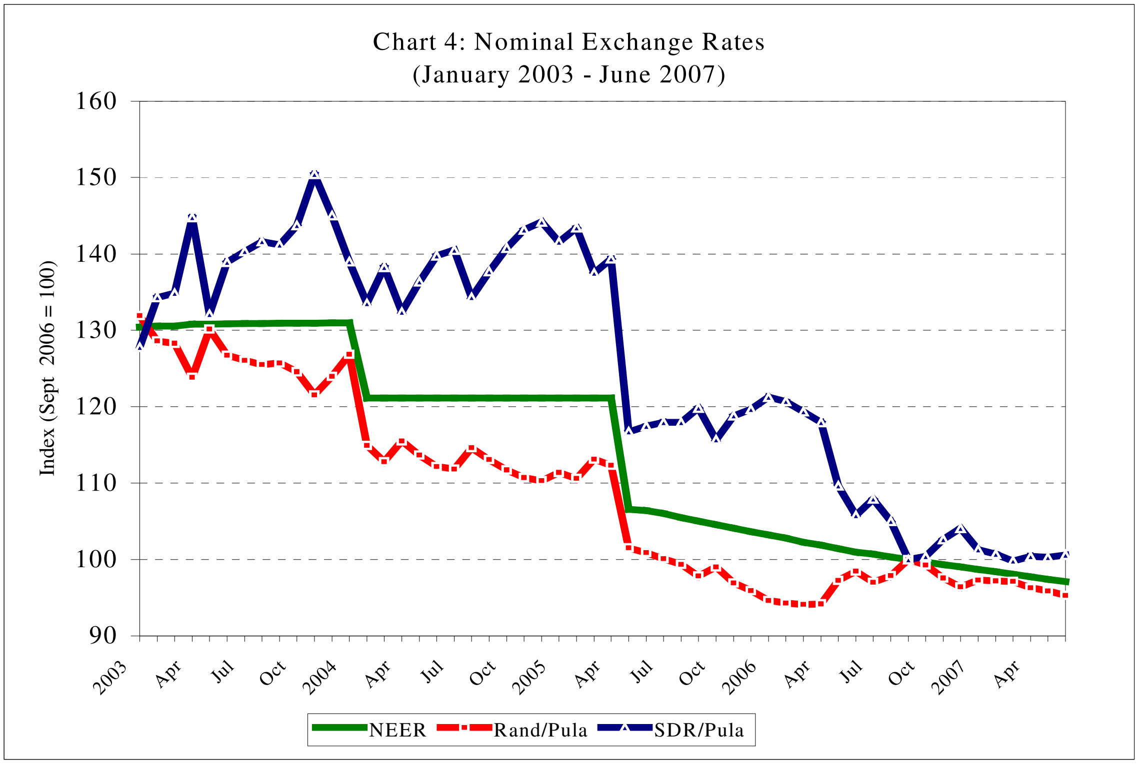


Chart 3: Annual Growth Rates of Credit and Government Spending
(January 2003 - June 2007)
25
20
15
10
5
0
-5
-10
Percent
2003
Apr
Jul
Oct
2004
Apr
Jul
Oct
2005
Apr
Jul
Oct
2006
Apr
Jul
Oct
2007
Apr
Total Credit
Total Govt.Exp



2.9 *Given an inflation objective higher than the annual rate of price increase in the trading partner countries, a downward crawl of the Pula was maintained in the first half of the year, as a result of which the NEER of the Pula depreciated by 1.9 percent. Against individual currencies, the Pula depreciated vis-à-vis the SDR by 3.4 percent (2.8 percent against the US dollar) and 1.1 percent against the rand in the six months to June 2007.*

2.10 *The REER[6] depreciated by 1.4 percent in the six months to June 2007, thereby indicating that the differential between the higher inflation in Botswana and in the trading partner countries was more than offset by the rate of crawl of the NEER. Bilaterally, the Pula depreciated by 1.5 percent and 1.4 percent against the rand and SDR, respectively, between December 2006 and June 2007.*

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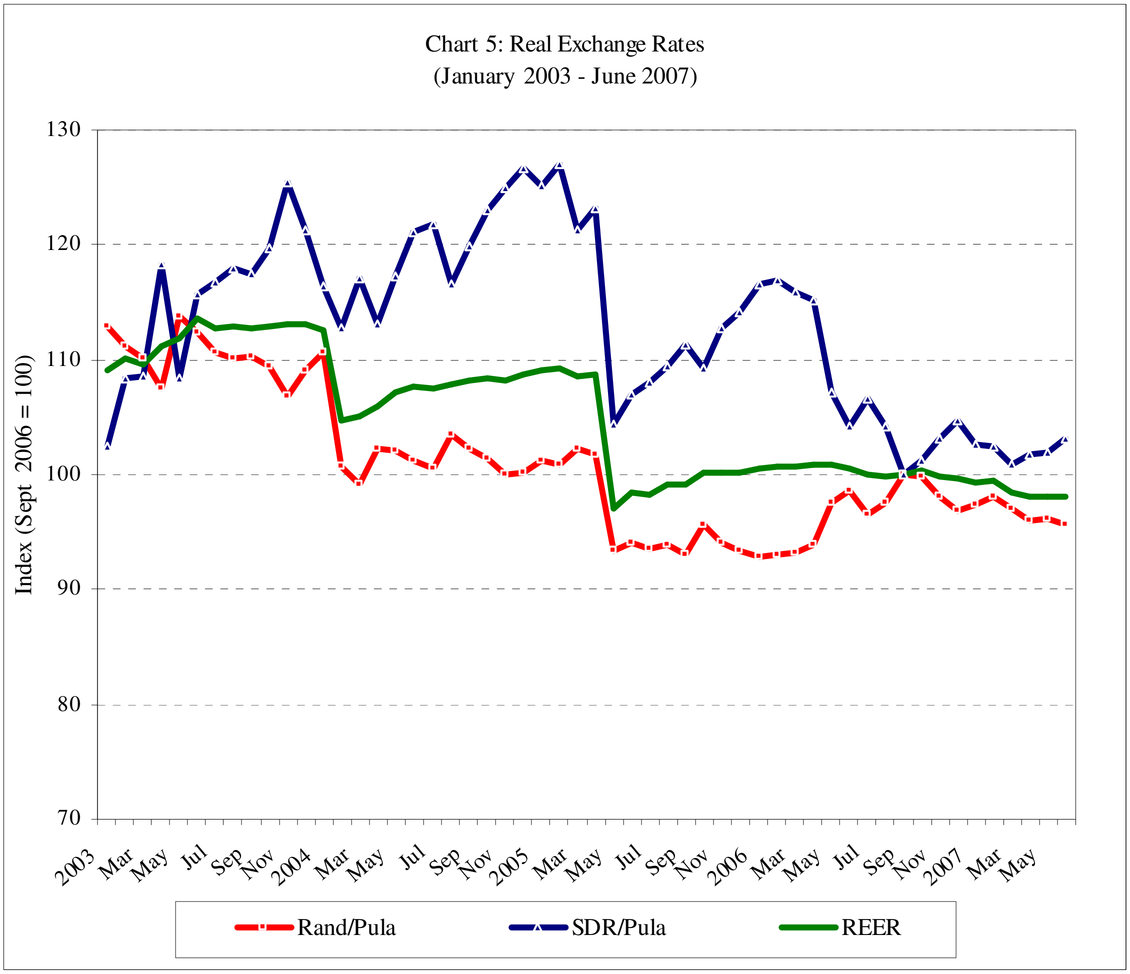
6 *Deflated using weighted average inflation for the SDR countries and South Africa's CPIX inflation.*



3. *Monetary Policy Implementation*

3.1 Demand pressures on inflation were largely restrained in the first half of the year against the background of a restrictive monetary policy stance and modest growth in government expenditure. Meanwhile, the high rate of annual growth of credit, which was at levels much higher than the desired range of 11 – 14 percent, appears to be associated with an increase in some aspects of financial intermediation and progress in implementation of government projects.[7] *Apart from the increase in domestic fuel prices due to the rise in international oil prices, there were minimal upward pressures on inflation from administered prices.*

3.2 In the context of the decline in inflation, which is expected to stabilise around the Bank's objective in the medium-term, the Bank Rate was reduced by 50 basis points from 15 percent to 14.5 percent in June 2007. In turn, commercial banks

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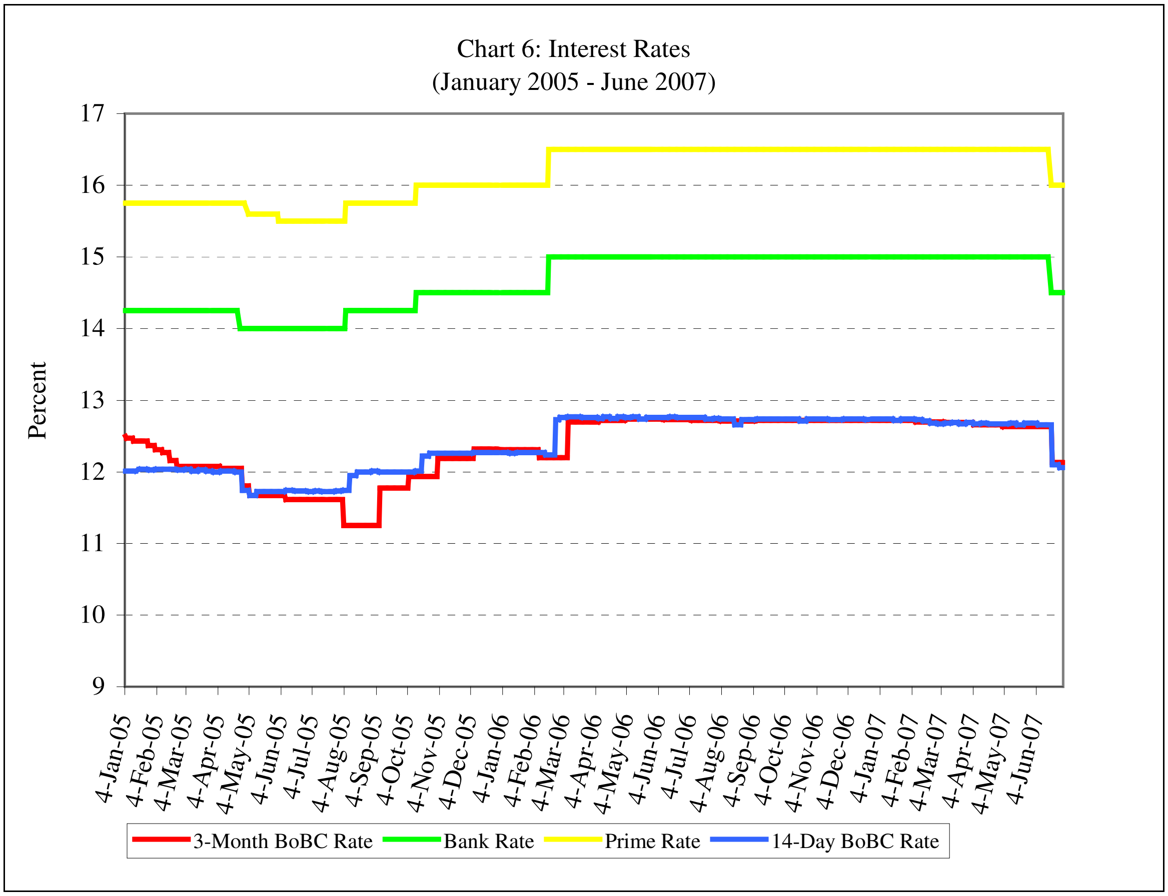
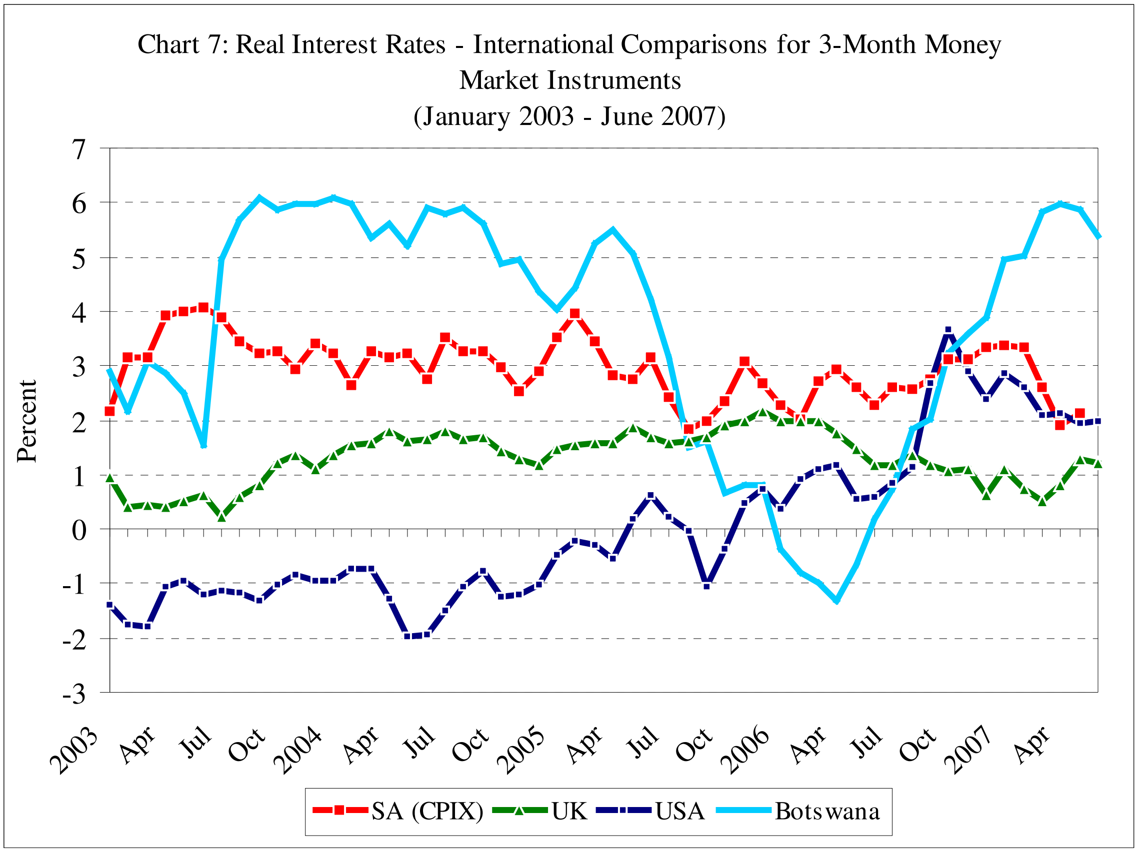
7 *In addition, there is a statistical effect of the 44 percent decrease in credit to parastatals in April 2006, following an early loan repayment by one of the parastatals, which dropped out of the calculation of the annual credit growth rate from May 2007. Moreover, the faster growth in commercial bank lending to households partly reflects the acquisition of Peo and Penrich micro lending companies by Bank Gaborone (Pty) Ltd.*

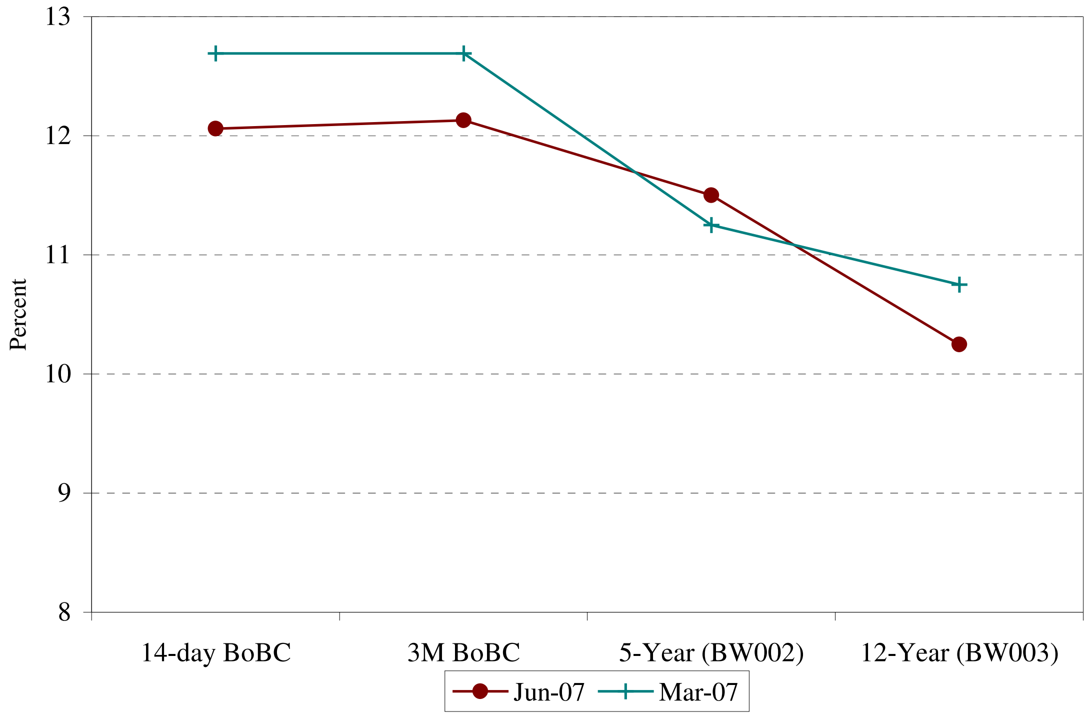
adjusted their interest rates, with the average prime lending rate falling from 16.5 percent in December 2006 to 16 percent. The average 88-day deposit rate also fell from 8.38 percent to 8.32 percent in the same period. The yield on BoBCs (3-month and 14-day paper) similarly declined from 12.72 percent in December 2006 to 12.13 percent in June 2007 and from 12.74 percent to 12.06 percent, respectively (Chart 6).





3.3 *As inflation declined significantly in the first half of 2007, real interest rates increased between December 2006 and June 2007, with the real 3-month BoBC rate increasing from 3.9 percent to 5.4 percent (Chart 7). In this context, the yield curve remains inverted, thus indicating expectations of low inflation and interest rates in the medium- to long-term, which is in addition to local investors' demand for longer-dated instruments (Chart 8).*

Chart 8: Yield to Maturity on BoBCs and Government Bonds



4. Inflation Outlook for the Remainder of 2007

4.1 World GDP growth is forecast to accelerate from about 3.4 percent in the first half of 2007 to 3.8 percent in the second half of the year, and thereafter decline to 3.3 percent in the first half of 2008. Underlying the rise in global output expansion is robust economic performance in the euro area and Japan (supported by strong domestic demand), as well as rapid growth in China and India. Despite the buoyant global economic performance and a sharp increase in international oil and some food prices, world inflation is forecast to rise moderately from 2.3 percent in the first half of 2007 to 2.7 percent in the remainder of 2007. It is considered that overall inflationary pressures will be restrained by the generally successful management of inflation expectations, particularly in an environment of increases in market competition and associated improvements in productivity.

4.2 Regionally, output in South Africa is expected to grow at 4.8 percent in 2007, lower than the 5 percent growth in 2006, with the weaker performance attributed mainly to a contraction of the mining sector and the slower manufacturing sector growth. Despite the forecast lower output growth, there are upside risks to inflation arising from increases in food and oil prices, as well as faster growth of household consumption expenditure. Overall, the CPIX inflation is forecast to remain marginally above the upper end of the South African Reserve Bank's target range of 3 – 6 percent in the second half of the year.

4.3 *In the domestic economy, it is expected that output growth in 2007 will be higher than the marginal 0.1 percent (revised from -0.8 percent) expansion in 2005/06, particularly in the context of a relatively high level of credit expansion and budgeted faster growth in government expenditure. However, given a restrictive monetary policy and the anticipated increase in economic activity rising from a low level, it is expected that demand pressures on inflation will remain moderate in the rest of 2007.*

4.4 *Inflation is expected to increase modestly in the second half of 2007 due to the lagged effects of past sharp increases in prices in South Africa, as well as the anticipated rise in the cost of staple food prices due to shortages, partly caused by the drought. The other upside risks to inflation include a possible further increase in fuel and other administered prices. In particular, the increase in the cost of fuel and government health services in July and September 2007 will initially contribute 1.4 percentage points directly to inflation in the third quarter, while there is a likelihood of an increase in water tariffs associated with drought. The Botswana Telecommunications Corporation has announced another round of tariff rebalancing towards the end of the year, with a possibility of large cost increases for some services, although these could be offset by reductions for other services. It is anticipated, therefore, that inflation will stabilise around the upper end of the 4 – 7 percent inflation objective range.*

5. Monetary Policy Stance

5.1 *At the beginning of 2007, the Bank maintained the annual inflation objective of 4 – 7 percent, although the forecast for trading partner countries' inflation of 4 – 6 percent suggested that the Bank should lower the upper end of the range. In the circumstances, the Bank considered it desirable to accommodate the higher level of inflation, which was largely due to transitory factors and to aim for a reduction of inflation over a gradual path and consistent with the medium-term inflation objective of 3 – 6 percent.*

5.2 *Going forward, average inflation for the trading partner countries is forecast to be in the range of 4 – 5 percent, and this may be interpreted to imply a need to reduce the upper end of the Bank's annual inflation objective. However, it is considered more realistic to maintain the inflation objective of 4 – 7 percent for the remainder of the year. The short-term inflation path is largely already determined by recent faster price increases in South Africa, as well as by the latest and anticipated increase in administered prices. It is, therefore, unlikely in the short-term for monetary policy to achieve a significant reduction in inflation, while it is considered that the current monetary policy stance and its influence on expectations should ensure an achievement of the Bank's price stability objective over the medium-term. Overall, the maintenance of the 4 – 7 percent inflation objective should reinforce the Bank's desire to achieve low inflation through a gradual adjustment path without undermining sustainable economic growth. Meanwhile, a modest downward crawl of the exchange rate would complement* *monetary policy towards achieving stability of the REER. Against the background of a narrowing differential between inflation in Botswana and in trading partner countries, a lower annual rate of crawl was implemented in July 2007.*

6. Summary and Conclusions

6.1 Inflation declined from 8.5 percent in December 2006 to 6.4 percent in June 2007, thus falling within the annual inflation objective range of 4 – 7 percent for four consecutive months, as transitory factors dropped out of the inflation calculation and the monetary policy stance focused on maintaining underlying inflation within the Bank's objective. While there are risks of inflation volatility in the short-term, due to faster price increases in South Africa arising from supply shortages of some goods and services, as well as possible large increase in some administered prices, it is expected that inflation will remain close to the upper end of the inflation objective range in the remaining part of 2007.

6.2 Pre-emptive monetary policy tightening in the major economies, as well as global competition and productivity improvements, have so far moderated the upward inflationary pressures generated by the increase in international oil prices. In South Africa, although there are significant upside risks due to higher food and energy prices, the CPIX inflation is not expected to rise significantly above the country's target range of 3 – 6 percent in the second half of the year. Domestically, it is anticipated that demand pressures on inflation will continue to be restrained by a relatively restrictive monetary policy and moderate growth in government expenditure and personal incomes.

6.3 On the basis of the foregoing, the annual inflation objective range will be maintained at 4 – 7 percent for the remainder of the year and monetary policy will focus on ensuring that inflation arising from underlying demand pressures remains close to this range. To this end, the Bank will aim to contain expectations and any inflationary pressures arising from second-round effects of the increase in administered prices, with a view to attaining the medium- to long-term objective of sustainable low inflation. The Bank will, therefore, continue to monitor demand pressures and price developments with a view to taking appropriate monetary policy action in the interests of price stability.

Appendix

List of Excluded Items

Item Code	***Item Description***
135	*Monthly rent BHC Type 2 "Improved"*
136	*Monthly rent BHC House Type LC49*
149	*Water: 10 kls per month in rural areas*
150	*Water: 10 kls per month in urban areas*
151	*Water: 20 kls per month in rural areas*
153	*Electricity, 100 kwh per month*
154	*Electricity, 500 kwh per month*
156	*Paraffin, per litre*
227	*Consultation with Government doctor*
234	*Rate to stay in a public hospital for 24 hour in a private ward (bed only)*
247	*Petrol per liter*
248	*Diesel per liter*
254	*Road worthiness test*
255	*Train fare, economy, Lobatse-Francistown*
256	*Train fare, economy, Gaborone–Lobatse*
257	*Bus fare, single, Gaborone-Mochudi*
259	*Taxi fare in Gaborone (Not "special")*
260	*Bus fare, single, Gaborone-Francistown*
261	*Minibus fare, within cities/towns/villages*
266	*Local Letter tariff rate 0.5 Kg*
267	*Air Parcel to Europe (0.5 Kg)*
268	*Rental of Post Office box*
269	*Airmail letter, 10g, Gaborone to Maun.*
271	*Telephone Installation*
272	*Telephone Charges/rate within zone (per second charge)*
273	*Telephone Charges/rate between zone (per second charge)*
274	*Telephone rate international (per second)*
275	*Telephone charge BTC to Orange (per second charge)*
276	*Telephone charge BTC to MASCOM (per second charge)*
310	*Admission to Premier football match, uncovered stands*
324	*Kutlwano*
336	*School fees (Senior Sec.) public school*
337	*Junior Secondary School fees (public)*
338	*College and university fees*
369	*Employee contribution to medical aid, Standard Benefit, 1, starting salary*
371	*Fully comp. insurance - Toyota Corolla 1.4*

374	*Levy + loan (P3500) interest on SHHA plot*
376	*Driver's License charge*
377	*Annual road tax - Hilux 2.0 pick-up*
378	*Annual road tax - Toyota Corolla 1.4*
379	*Fee for the issue of a passport*
380	*Council rates to house + plot valued at P200,000*