2008 MONETARY POLICY STATEMENT - MID-TERM REVIEW

1. Introduction

1.1 The Mid-Term Review (MTR) of the 2008 Monetary Policy Statement (MPS) is intended to assess progress made in achieving the medium-term inflation objective that is outlined in the 2008 MPS. The review also evaluates the medium-term financial and economic outlook and other factors that are likely to influence policy formulation in the remainder of the year. Overall, the assessment informs stakeholders of the key developments and, in turn, the appropriate monetary policy stance with a view to influencing inflation expectations in the medium term.

1.2 The medium-term inflation objective of 3 – 6 percent represents the Bank's view of price stability, which is the level of inflation that is consistent with sustainable long-run economic growth of the economy. Low inflation close to that prevailing in the country's trading partners contributes to attaining stability of the real effective exchange rate (REER). It was anticipated at the beginning of the year that domestic inflation would remain above the objective range in 2008, but would decline towards the upper end of the medium-term range. However, as a result of significant shocks to prices, inflation rose to a much higher level in the first half of the year and, consequently, there has been a deterioration in the outlook for price developments. Hence, it is expected that domestic inflation will increase further in the near-term, and is forecast to peak in the last quarter of 2008, before decreasing towards the Bank's inflation objective at the end of 2009.

1.3 In controlling inflation, the Bank uses interest rates and open market operations to influence aggregate demand. However, in place of focusing on credit growth as the key indicator of domestic demand or intermediate target, the Bank now explicitly considers the more inclusive medium-term inflation forecast. Monetary policy, therefore, responds to deviations of the medium-term inflation forecast from the inflation objective range, rather than the current level of inflation or the short-term inflation forecast.

1.4 Central banks around the world currently face a policy dilemma, especially given the prospects of stagflation, where a sharp increase in inflation occurs at a time of slowing economic growth. At the same time, the global financial system remains weak in the wake of the US sub-prime mortgage lending crisis and the resultant credit crunch. Accelerating inflation calls for monetary policy tightening, whereas declining economic growth warrants policy easing. Even though the sharp surge in international food and energy prices are considered the main contributing factors to current global inflationary pressures, the broader financial imbalances in the world economy follow an extended period of accommodative monetary policy in many countries, which may have also contributed to the current situation. It is, therefore, important that this review articulates the sources of inflationary pressures and provides the basis for a clear *and measured response to these challenges that is relevant to the specific situation in Botswana.*

2. Monetary Policy Framework and Objectives

2.1 The objective of monetary policy in Botswana is to achieve a sustainable, low and predictable level of inflation, which contributes towards the broader national objective of sustainable economic development. The modifications to the monetary policy framework contained in the 2008 MPS enhance both policy analysis and response, particularly in relation to the assessment of factors that determine future price developments, including the respective magnitude of the impact on domestic inflation and the transmission lags. The important factors that are considered in determining the future path of inflation include, among others, developments on demand pressures, interest rates, exchange rates, administered prices, inflation expectations, as well as relevant external developments. In this regard, the consideration and assessment of prospective developments involves both statistical and expert analysis.

2.2 The Bank's monetary policy goal is to achieve the 3 – 6 percent medium term price stability objective. In addition to guiding the attainment of the inflation objective, the medium term (rolling three-year period) represents a period over which the path for inflation is forecast; it is also a reasonable period over which monetary policy can affect demand pressures and price developments. In the context of regular policy reviews that include deliberations of the Monetary Policy Committee and Monetary Policy Statements, deviations of the inflation forecast from the objective range would signal the need for a policy response. Notionally, this involves a response to projected trend of inflation that is either significantly higher or lower than the price stability objective.[1] Monetary policy is, therefore, forward-looking, given that the currently observed level of inflation or the short-term forecast has already been determined by past developments, while short-term price movements are mainly influenced by shocks and do not respond to current policy action to any significant degree. Focusing on the medium-term objective also recognises the time lag between policy action and its impact on the economy in general, and inflation in particular; the time lag extends beyond one year.

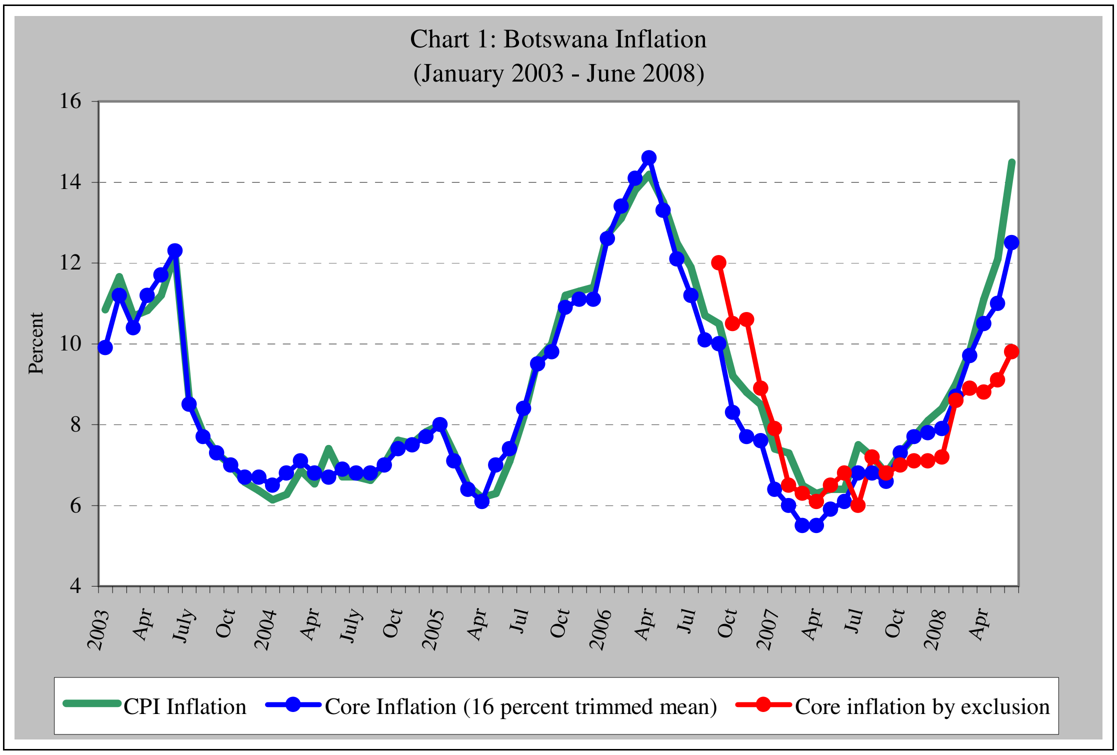
2.3 In view of the fact that the economic environment within which monetary policy operates is characterised by uncertainty and the likelihood of different outcomes than earlier anticipated, inflation projections are subject to review. In particular, over the past year, policy makers across the world have had to regularly revise their inflation and growth forecasts due to unanticipated increases in, and volatility of, international oil and food prices, as well as the uncertain impact of the financial turmoil resulting from the collapse of the sub-prime mortgage

1 Apart from the harmful effects of high inflation, the price stability objective takes account of the fact that significantly low levels of inflation could be indicative of subdued economic activity, which requires policy easing to stimulate output growth.

market in the USA. The Bank, therefore, regularly reviews recent and anticipated economic and financial developments and their impact on the inflation outlook which, in turn, informs the policy response to keep inflation under control. This is augmented by announcements of policy decisions and the Bank's view of the main influences on price developments, as well as the outlook for inflation, which guide expectations with respect to both the policy stance and inflation.

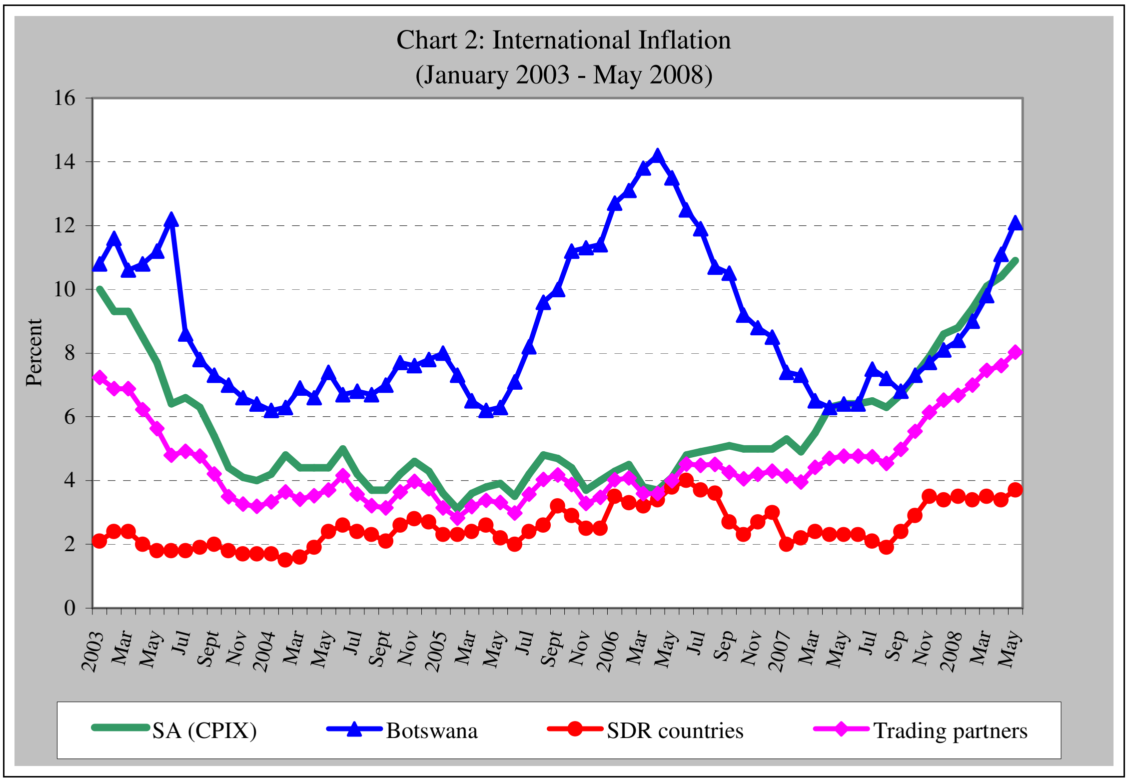
3. Inflation in the first half of 2008

3.1 Headline inflation continued to increase in the first half of 2008, mainly due to the substantial increase in the price of food and oil. Annual inflation was 8.1 percent in December 2007 and rose to 14.5 percent in June 2008, thus remaining above the upper end of the Bank's medium-term inflation objective range of 3 – 6 percent in the first six months of the year. Both measures of core inflation, i.e., the 16 percent trimmed mean and core inflation by exclusion, also maintained an upward trend in the same period, except that core inflation by exclusion dropped slightly in April, thus reflecting the exclusion of fuel prices in this measure of inflation.



3.2 Domestic inflation in the first half of the year was much higher than the average inflation of trading partner countries, although South Africa's inflation was very close and above that of Botswana between November 2007 and March 2008. Overall, average inflation for trading partner countries also trended upwards in the same period, rising from 6.5 percent in December 2007 to 8 percent in May 2008 reflecting rising international food and energy prices.

3.3 In South Africa, CPIX inflation[2] rose from 8.6 percent in December 2007 to 10.9 percent in May 2008, due to rising international food and energy prices. The deteriorating inflation outlook in South Africa was aggravated by the increase in the price of electricity in April 2008 and the subsequent announcement of further increases, as well as the weakening of the rand. These developments have had a negative impact on inflation expectations in South Africa. Consequently, the CPIX inflation has remained above the upper limit of the South African Reserve Bank's inflation target range of 3 – 6 percent since April 2007.



3.4 A breakdown of the domestic consumer price index (CPI) indicates that the increase in Botswana's inflation was mainly due to rising international energy and food prices and resulting adjustments in associated administered prices (Chart 3). When food and fuel are excluded, inflation has been within the Bank's inflation objective range since August 2007. Between December 2007 and June 2008, petrol, diesel and paraffin prices went up by 40 percent, 76.8 percent, and 84.4 percent, respectively. As a result, the annual increase in fuel prices[3] accelerated from 12.6 percent in December 2007 to 56.1 percent in June 2008, while the year-on-year increase in food prices rose from 15.3 percent in December 2007 and peaked at 18.6 percent in February 2008, before falling to

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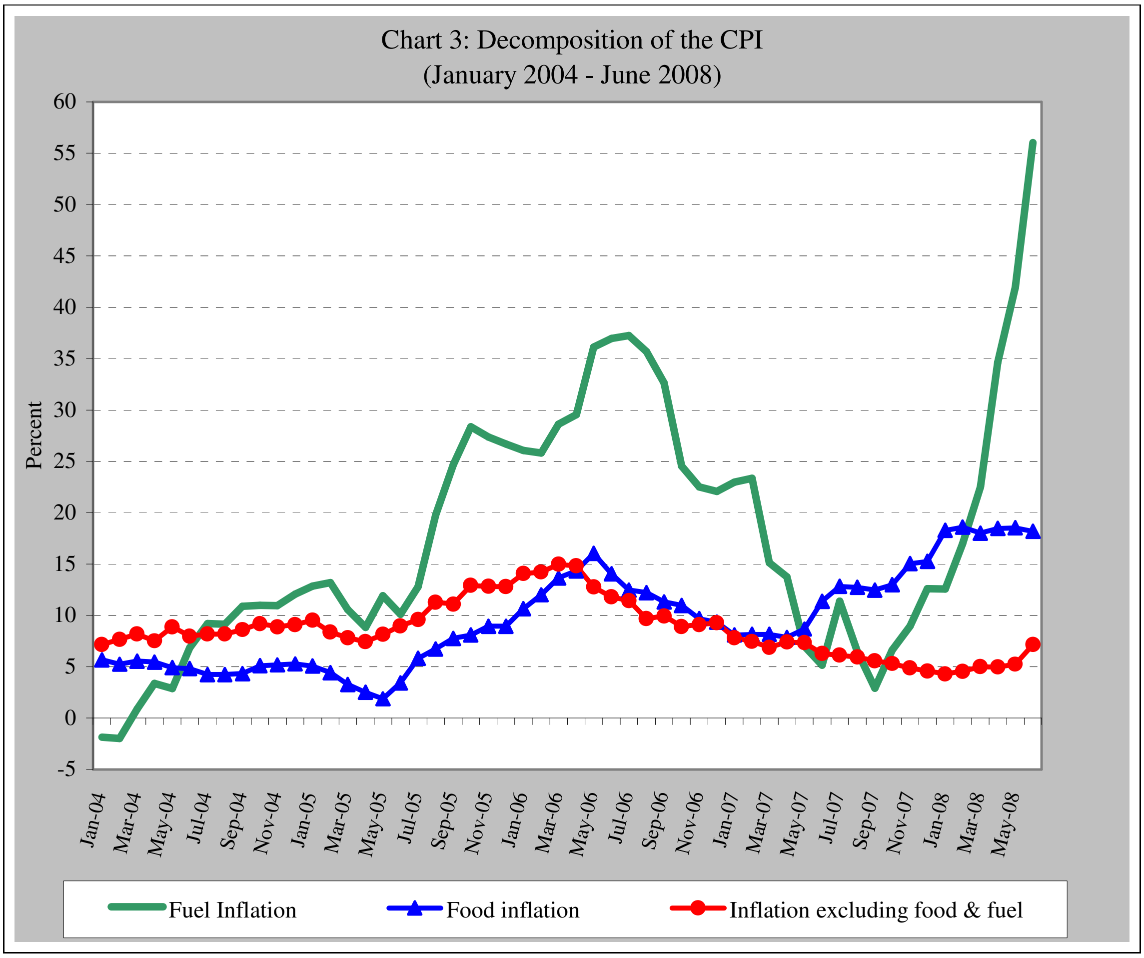
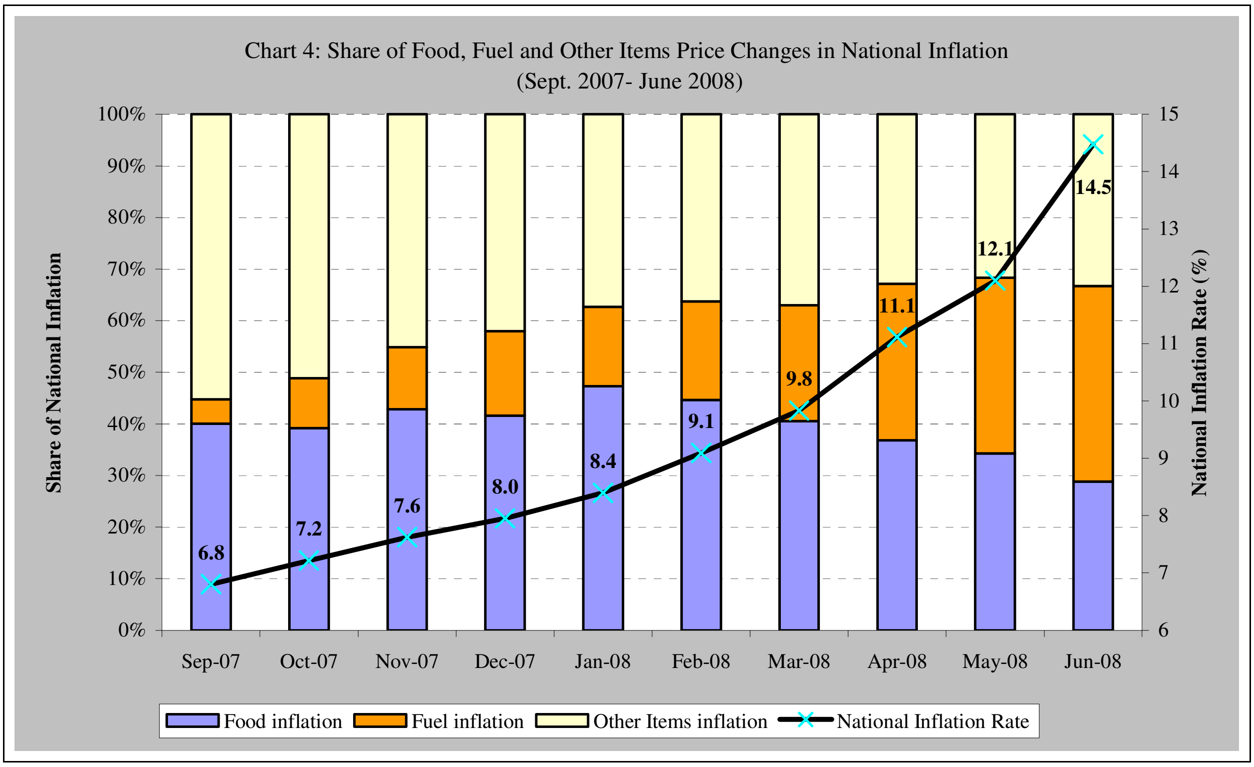
2 *CPIX inflation is the South African Reserve Bank's target measure of core inflation.*

3 *This relates to the category "operation of personal transport" in the CPI basket which, among others, includes the weighted contributions of the change in diesel and petrol prices.*

18.5 percent in both April and May and to 18.2 percent in June (Chart 3). Thus, inflationary pressures are less generalised, but they are confined to food and administered prices, including fuel prices, as indicated by the increasing contribution of these items to inflation, from September 2007 (Chart 4). However, there has recently been a relatively larger and increasing contribution to inflation of the rise in fuel prices compared to the effect of food prices.





3.5 *Imported tradeables inflation rose from 7.7 percent in December 2007 to 19.3 percent in June 2008, thus reflecting the impact of external price developments, while inflation for domestic tradeables rose more slowly from 15.2 percent in December 2007 to 15.9 percent in January 2008, before trending downwards to 14.2 percent in June 2008. Consequently, the all tradeables inflation rose from 10.3 percent to 17.5 percent in the same period. Meanwhile, non-tradeables inflation was relatively low, at single digit, and rose at a slower rate to 7.3 percent in June 2008.*

3.6 *Domestic demand pressures on inflation continue to build, particularly as indicated by the high growth rates of credit and government expenditure and the associated acceleration in output growth. Output expansion in 2006/07 is estimated at 6 percent, a significant increase from the 0.5 percent growth for 2005/06, with strong performance in both the mining and non-mining sectors. In addition, more recent estimates of GDP for the first two quarters of 2007/08 (July to December 2007) suggest that the pace of non-mining private sector growth has accelerated further to 10 percent on an annual basis.*

3.7 *There are also upward demand pressures resulting from fiscal expansion, an increase in disposable incomes and the associated high level of annual credit expansion. The year-on-year growth in total government development and recurrent spending rose from 11.4 percent in March 2007 to 23.2 percent in*

March 2008; this is lower than the revised estimate of 32.2 percent annual increase in expenditure for the 2007/08 fiscal year, which was announced in the 2008 Budget Speech. The increase in the yearly growth of government spending between March 2007 and March 2008 reflected faster annual expansion in both development and recurrent expenditure, from 6.6 percent and 12.7 percent to 59 percent and 14.1 percent, respectively. Total recurrent and development expenditure for the fiscal year 2008/09 is budgeted to grow at an annual rate of 14.7 percent.[4] Meanwhile, credit growth accelerated from 24.4 percent in December 2007 to 27.9 percent in March 2008, before declining to 26.4 percent and 26 percent in April and May 2008, respectively.

4. Monetary Policy Implementation in the First Half of 2008

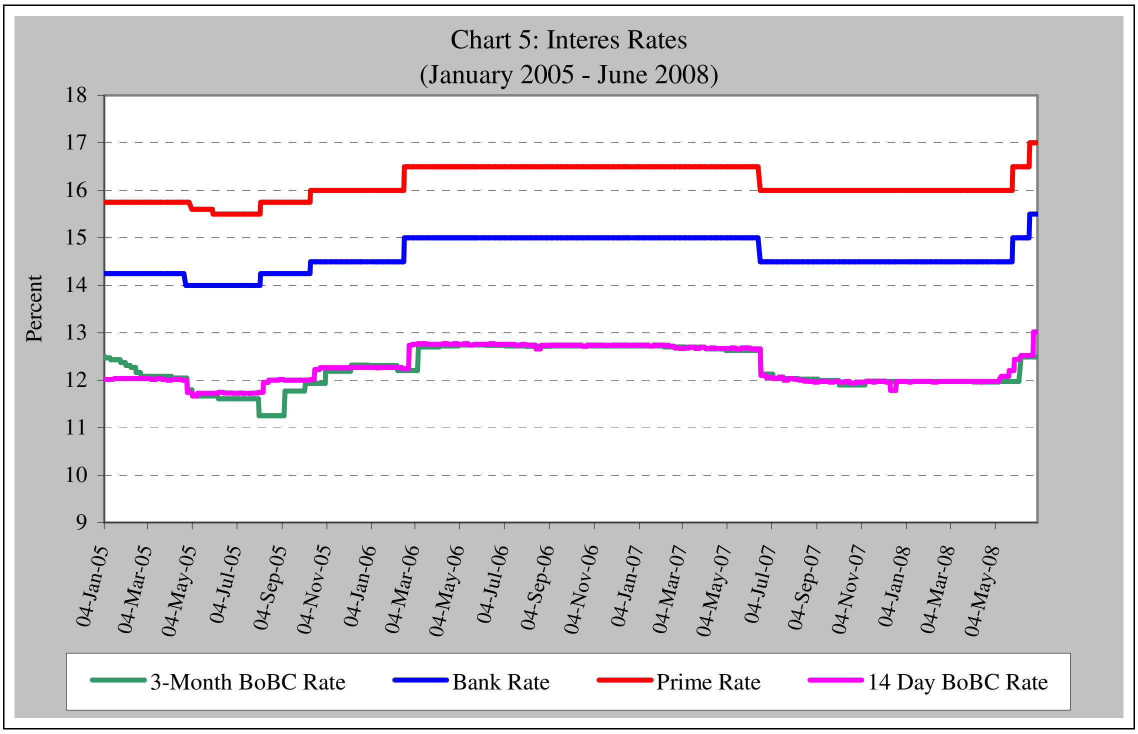
4.1 As reported in the 2008 MPS, inflation was expected to peak at around 9 percent in the second quarter of 2008 and to fall within the inflation objective by the end of 2009. While the forecast indicated a short-term deterioration in the inflation outlook, the medium-term projection, which is more important for monetary policy analysis, indicated a sustained decrease in inflation going forward. Accordingly, based on the inflation forecast and taking into account the underlying assumptions, the Bank Rate was maintained, since June 2007, at 14.5 percent in the first four months of 2008.

4.2 However, at the time, there were risks that food and fuel prices, other administered prices and the impact of a wage-induced increase in demand could be stronger than expected, thereby affecting the domestic economy and inflation expectations. Other factors considered in the outlook were either neutral or favourable with respect to containment of inflation pressures. Domestic output growth, which was assessed to be above its long-term trend, was estimated to be declining, while the Pula was appreciating against the rand, thereby exerting downward pressure on domestic inflation. On balance, and considering the overall risks, the decision to maintain the Bank Rate at 14.5 percent in April was accompanied by a signal that the bias was towards future policy tightening.

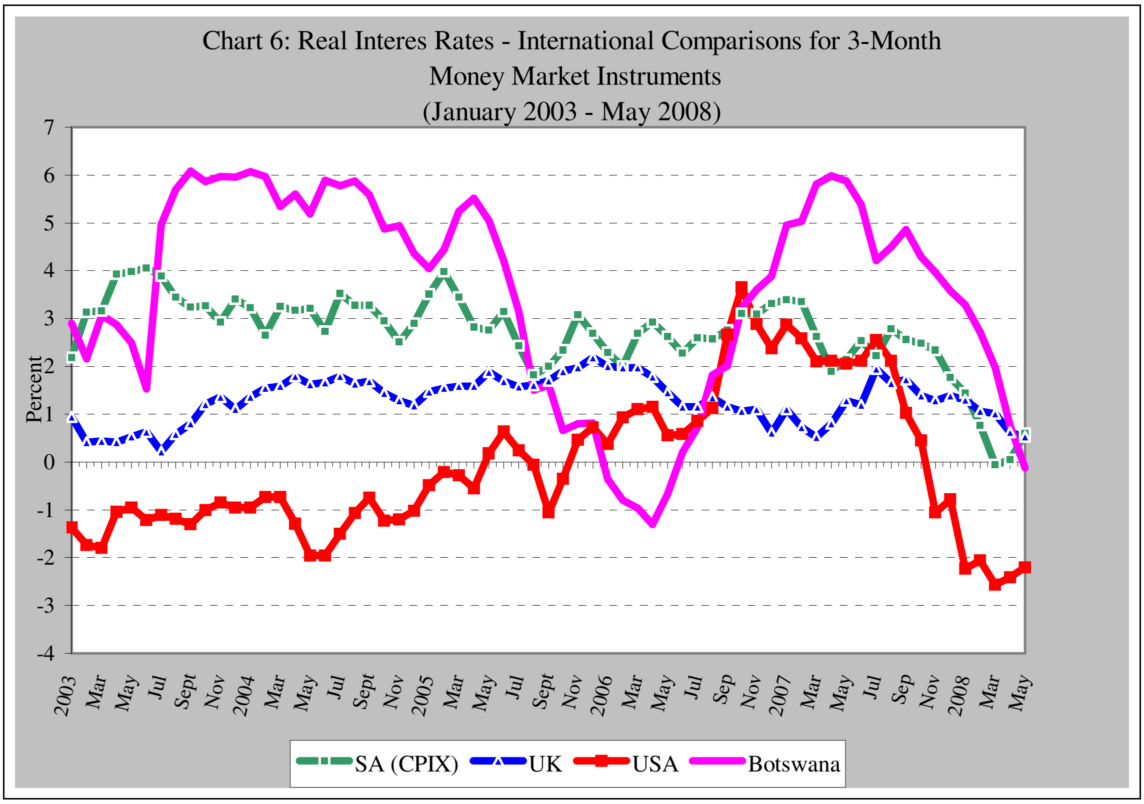
4.3 Subsequently, in May and June 2008, it was considered that the inflation outlook had deteriorated, primarily as a result of upward revisions to the assumptions on several determinants of domestic inflation. The balance of risks to the inflation outlook was on the upside, mainly reflecting developments with respect to South Africa's inflation and supply-side shocks that outweighed the strengthening of the Pula against the rand and projected moderation of demand pressures. In the context of the significant changes in economic developments and underlying assumptions, revised forecasts estimated annual inflation to peak at a higher level than previously forecast. Accordingly, the Bank increased the Bank Rate by 50

4 The 14.7 percent annual growth in government spending does not include the 15 percent increase in public sector salaries.

basis points each in May 2008 and June 2008 to 15.5 percent. In response, Bank of Botswana Certificate (BoBC) interest rates and commercial banks' lending and 88-day deposit interest rates were increased (Chart 5).



4.4 *As inflation continued to trend upwards in the first half of 2008, real interest rates decreased between December 2007 and June 2008, with the real 3-month BoBC rate and the real 14-day BoBC rate decreasing from 3.58 percent to -1.76 percent and -1.29 percent, respectively. Similarly, in the same period, the real prime lending rate and 88-day deposit rate fell from 7.31 percent to 2.18 percent and 0.38 percent to -4.91 percent, respectively.*



5. *Inflation Outlook in the Medium-Term (2008-2010)*

5.1 *The forecast inflation path is determined by a combination of demand-pull pressures resulting from real economic activity, imported inflation and other exogenous factors. International economic and financial developments, such as economic growth, interest rates and the inflation outlook, also play an important role in determining the inflation outlook for Botswana. Of particular importance are the economic and financial developments in South Africa, which is Botswana's major trading partner.*[5]

5.2 *Economic growth in South Africa is projected to slow down in 2008, from 5.1 percent in 2007 to 3.3 percent in 2008, reflecting mainly weaker consumer and business confidence, capacity and skills constraints in certain sectors, as well as the impact of electricity supply shortages. Despite the forecast lower output growth, there are upside risks to inflation arising from increases in food, oil and electricity prices and the forecast depreciation of the rand against international currencies, particularly the US dollar. Overall, annual inflation in South Africa (CPIX) is projected to remain above the upper end of the 3 - 6 percent inflation target until the end of 2009. To this end, the South African Reserve Bank is expected to maintain the current tight monetary policy stance going forward, in order to bring inflation back to the target range.*

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5 *Forecasts for external variables are obtained mainly from the Reuters survey of forecasters.*

5.3 *World economic performance remains weak with global output growth projected to decrease from 3.5 percent in 2007 to 2.5 percent in 2008. The forecast decline in global economic activity is attributed to anticipated weaker performance in the USA and other major industrial countries, which is not offset by continued robust growth in emerging market countries. Meanwhile, there are significant upside risks to global inflation due to the sustained increase in energy and food prices. Furthermore, there is concern that the management of inflation expectations by central banks is weakening, with possible negative consequences for restraining the general increase in the price level. This has exacerbated the dilemma confronting central banks, as the need to tighten monetary policy to control inflation is constrained by considerations for economic growth. In the circumstances, several major central banks have adopted a bias towards a neutral stance.*

5.4 *In the domestic economy, output growth is expected to remain above the long-term growth trend, partly sustained by relatively high levels of credit expansion and growth in government expenditure, with a likely upward pressure on inflation, albeit moderated by generally tight monetary conditions. To the extent that the current monetary policy stance is maintained, inflation is expected to fall and reach the Bank's objective range at the end of 2009. However, this scenario could be adversely affected by negative developments in the international cost of energy and food, as well as other administered prices.*

5.5 *The rate of crawl of the exchange rate, which is based on the differential between the Bank's inflation objective and forecast inflation for trading partner countries, is not expected to result in a substantial nominal exchange rate adjustment in 2008, particularly against the South African rand. The rate of crawl should, therefore, not add significantly to inflationary pressures, especially in an environment of a relatively restrictive monetary policy.*

5.6 *In June, inflation forecasts for the remainder of 2008 were revised upwards from the December 2007 forecasts, and average inflation is now forecast to peak in the last quarter of the year. In the near term, this revision primarily reflects the higher than expected increase in South Africa's inflation and the impact of adjustments to administered prices of fuel, electricity and transport costs, as well as the increase in food prices, which are driving inflation above the 3 – 6 percent inflation objective. However, inflation is expected to fall within the Bank's 3 – 6 percent inflation objective in the last quarter of 2009. This is primarily a result of the expected decline in South Africa's inflation over this period. In addition, the domestic restrictive monetary policy stance is expected to contribute to the slowdown in inflation during the remainder of the forecast period.*

5.7 *Another significant factor influencing the medium-term trend in inflation is public expectations of inflation. Inflation expectations have an important bearing on whether transitory influences on prices, such as changes in energy costs, become* *embedded in price and wage decisions and have a lasting impact on the rate of inflation. The deterioration in inflation expectations is evident in the latest Business Expectations Survey conducted by the Bank. The survey indicates average inflation of 9.8 percent for 2008, while for 2009, inflation is expected to average 10.2 percent. Consistent with this, and as an early sign of emerging possible second round effects, there are heightened expectations of an increase in production costs, particularly transport and utility costs, and this reflects the significant rise in prices of energy sources (fuel and electricity).*

5.8 *Furthermore, there are risks to the forecast inflation path emanating from a broad range of internal and external factors, e.g., possible increase in administered prices and a further increase in international oil prices, price developments in South Africa, the rand/Pula exchange rate, and the future stance of fiscal and incomes policies. These possible developments could alter the major assumptions underlying the forecast path for domestic inflation. The inflation outlook and monetary policy stance would have to change in response to significant deviations from the projected path of these major determinants.*

6. Monetary Policy Stance

6.1 *Recent economic developments and the assumptions underlying the current macroeconomic forecast have revealed the emergence of additional risks. In particular, external shocks have turned out to be more persistent than expected, thus reflecting extended adjustments of the relative prices of food and fuel due to the shifting balance of global supply and demand. As a result, the risks of second-round effects have increased, and this necessitates an upward revision of the Bank's forecasts. Consequently, and in the environment of increased uncertainty, pre-emptive monetary policy action has been necessary as indicated by the successive increases in the Bank Rate in May and June 2008. Going forward, and to ensure a steady decline in inflation, there is a need to maintain the current tight policy stance, in order to restrain the second-round effects of the increase in administered prices and refocus expectations of a fall in inflation towards the Bank's medium-term objective.*

6.2 *Overall, there are significant upward risks to the Bank's inflation outlook, which could lead to a higher than expected inflation outcome. Output growth projections indicate moderate risks to inflation, partly reflecting the past relatively tight monetary conditions, while the major threat to price developments is predominantly external and supply-side related. In the circumstances, monetary policy has to balance the trade-off between the need to contain inflation expectations and second-round effects and the desire to support output expansion.*

6.3 *Monetary policy can, however, be effectively employed to counteract systematic effects that lead to second-round effects such as a general increase in prices that can induce a wage-price spiral and render inflation uncontrollable. In the current conditions, prudent monetary policy is a necessary but not sufficient* *condition for attaining price stability. The support of complementary fiscal policy and the implementation of government structural reforms, such as skills development and encouragement of entrepreneurial activities that can yield significant productivity gains, are critical in this respect. These can help to enhance the resilience of the economy and its ability to maintain macroeconomic stability against serious external shocks.*

7. Summary and Conclusions

7.1 Annual inflation trended upward in the first half of 2008, mainly due to an increase in international fuel and food prices. There were also upward inflationary pressures emanating from the increase in South Africa's inflation, which has been above the upper end of the South African Reserve Bank's inflation target range since April 2007.

7.2 A possible sustained increase in energy and food prices remains a significant upside risk to global inflation; in fact there has been an increase in inflation in most major countries and emerging economies in the recent past. Against the background of concerns pertaining to economic growth prospects in major economies, policy makers are confronted with challenging policy choices.

7.3 With inflation forecast to remain above the price stability objective in the short term, the challenge for monetary policy remains to bring inflation back to the 3-6 percent medium-term inflation objective. Therefore, the Bank will aim to anchor inflation expectations and contain 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 future direction of monetary policy will, therefore, be largely influenced by prospective domestic and external factors and their impact on the outlook for inflation and economic activity in Botswana. To this end, the Bank remains committed to responding appropriately to all economic and financial developments to keep inflation under control.