MONETARY POLICY STATEMENT - 1999

Introduction

Monetary policy is directed mainly at achieving the first principal objective of the Bank of Botswana – promoting and maintaining monetary stability. In conjunction with fiscal, wage, trade and exchange rate policies, monetary policy aims to foster macroeconomic stability, which is a crucial precondition for achieving sustained development, high employment, and rising standards of living for Batswana.

Overview of 1998

Economic Performance

Despite tumbling stock markets around the world, and the fear of global economic recession, the Botswana economy is performing well, particularly in comparison with most other emerging markets. Many sectors of the economy are currently experiencing growth, while inflation is low by historical standards. However, while the overall economic situation is relatively healthy, there are some serious concerns on the horizon. In the short term, there is a danger of an overheating domestic economy under pressure from increasing Government spending, booming construction activity and rising consumer borrowing and spending.

A further concern arises from prospects of a slowdown in regional and global economic growth. Even if the world economy avoids a recession, both global and regional economic growth rates are likely to be low in 1998 and 1999, and this will adversely affect Botswana's exports. Diamonds, in particular, look especially vulnerable, but so do the increasingly important regional exports. The international diamond market has been under considerable stress since Japan and the Asian Pacific financial and economic crisis which began in the second half of last year and later spread to other parts of the world. The lower diamond sales resulting from the depressed demand in Asian markets, will be felt on the Government budget. Thus, the coming months are likely to see a moderate surge in inflation, and the first Government budget deficit in over a decade.

Monetary Trends

Money Growth

Over the 12-month period to August 1998, the narrowly defined money supply, M1 (currency outside banks plus demand deposits), maintained its volatile trend, recording the highest year-on-year growth rate of 35 percent in August 1998. This increase in M1 is mainly attributed to the expansion of current deposits, which increased by 33.5 percent between August 1997 and August 1998. Growth in the broader measures of the money supply were relatively high throughout the year, with M2 growing by 30.1 percent, M3 by 23.7 percent, and M4 by 25.1 percent, over the year to August 1998.

Commercial Bank Credit

Total lending of commercial banks and ulc continued to rise very rapidly throughout most of 1998, recording growth rates that significantly exceeded levels considered appropriate for monetary stability. Total credit increased from P1 989 million in October 1997 to P2 864 million in October 1998 in nominal terms, and from P1 843 million to P2 506 million in real terms, with corresponding nominal and real growth rates of 44 percent and 35.9 percent, respectively. Total credit to the household sector increased from P934 million in nominal terms and P865 million in real terms, to P1 350 million and P1 181 million, respectively, recording nominal and real growth rates of 44.6 percent and 36.5 percent, respectively, over the year to October 1998.

On the other hand, during the same one year period ending in October 1998, private business credit increased by a nominal 31.5 percent and 24.1 percent in real terms, from P992 million and P919 million to P1 304 million and P1 141, respectively. In August and September 1998, growth in private business credit, which for some time lagged behind household credit, exceeded that of the latter sector by noticeable margins. Growth in private business credit has now been significantly positive in real terms for ten consecutive months to October 1998, a welcome development, which is likely to be reflective of increased investment. The very rapid growth in credit, although anticipated, leaves authorities wary of the fact that such high growth rates in credit could cause macroeconomic instability and financial distress in future. Over-borrowing and poor investment would lead to businesses failing, and this, coupled with possible fluctuations in real estate and stock prices, could result in a large number of non-performing loans.

Interest Rate Development

The Bank of Botswana's objective of maintaining positive real interest rates (measured by the short term effective yield on the three-month Bank of Botswana Certificates) in line with those prevailing in major international capital markets, continued to be achieved throughout 1998, in respect of interest rates in the UK and USA. South Africa's real money market interest rates continued to be way out of line with those of Botswana.

During 1998, the Bank continued to use the Bank Rate in conjunction with Open Market Operations, as the main tools of monetary policy. Due to the continued steady decline in the year-on-year rate of inflation over the first half of 1998, coupled with favourable developments with respect to the growth of economic activity, the Bank Rate was reduced twice from 12.5 percent to 12 percent and then to 11.75 percent in January and March, respectively. However, in the second half of 1998, a build up of inflationary pressures due to both external and domestic factors prompted the Bank to take a pre-emptive measure by tightening monetary policy by 75 basis points to 12.5 percent in September 1998. Subsequent to these Bank Rate adjustments, the commercial banks responded by adjusting their prime lending rates accordingly; they currently stand at 14 percent.

Inflation

The first six months of 1998 saw a continuous fall in Botswana's 12-month inflation rate, except for the month of April, when the rate increased from 6.9 percent in March 1998 to 7.3 percent. At 7.7 percent at the start of the year, Botswana's annual inflation rate reached a low of 5.9 percent in July, September and October 1998, before rising to 6.2 percent and then to 6.4 percent in November and December 1998, respectively. The inflation trend in 1998 was in line with expectations of most analysts, who predicted reduced inflationary pressures during the first half of the year. This is because Botswana's inflation rate tends to follow the trend in South African inflation. Given the existing trading relationships between Botswana and South Africa, the two countries' inflation rates should not continuously diverge from each other for any extended period of time.

During the second half of the year, inflationary pressures in Botswana started building up. The pressures were largely a result of rising inflation in South Africa, domestic salary increases (which were implemented with effect from July 1998) and rapid growth of credit and government expenditure. The lagged effect of these factors was shown by the continuing downward trend in inflation, even sometime after these developments took place. Botswana's inflation rate only started rising in November 1998, when the rate stood at 6.2 percent, up from 5.9 percent in October 1998, and was followed by another increase to 6.4 percent in December 1998. Nevertheless, given the lag in pass-through of inflation in South Africa to Botswana, it is still premature to attribute the current upward trend to the above-mentioned factors.

Exchange Rate Developments

During 1998, the Pula exchange rate reflected the turbulence affecting the foreign exchange markets of emerging economies, in the wake of the financial crisis in Asia; the Pula depreciated against major international currencies. On the regional front, the Pula registered a modest appreciation *vis-à-vis* the Rand. Against the US dollar, pound sterling, Japanese yen, Deutsche mark and French franc, the Pula depreciated by approximately 21 percent, 20 percent, 15 percent, 21 percent and 21 percent, respectively, in the period May to August 1998. Thereafter, a substantial measure of stability returned to the foreign exchange market, and this saw the Pula regaining some of its lost strength although still trading at levels below those that prevailed at the beginning of the year.

Monetary Policy For 1999

The cornerstone of the current monetary policy is to achieve positive real interest rates in Botswana that are comparable to those in major international capital markets. The policy stance is also consistent with having a stable real exchange rate in Botswana, in which changes in nominal exchange rates mirror the differential between Botswana's rate of inflation and that of our major trading partners. Since the Bank of Botswana wants to avoid having to devalue the nominal exchange rate in order to maintain a stable real exchange rate, the aim of monetary policy in 1999 is to target an inflation rate which is comparable to the average inflation rate of Botswana's major trading partners.

Besides using interest rates to fight inflation, the Bank also aims at balancing the needs of savers and investors. Real interest rates should be high enough to provide a positive return to savers, and thus encourage savings; similarly, the level of interest rates should not discourage entrepreneurs from borrowing to finance viable investment projects.

It should be noted that keeping inflation low and stable is of considerable benefit to the general public, as it helps to ensure that the purchasing power of money is not eroded by rising prices. This, in turn, helps to encourage greater financial savings and more efficient investment, both of which will have salutary effects upon the country's ability to increase the rate of growth and improve standards of living.

The Bank will, therefore, continue to monitor inflationary developments very closely, and pursue policies which will assist in bringing inflation down. In doing this, the Bank will focus mainly on two main areas. First, the Bank will ensure that Botswana's producers of goods and services remain competitive in domestic, regional and international markets. With a stable Pula pegged against a basket containing the SDR and the Rand, this requires that Botswana's inflation rate must be kept below that of South Africa, which is currently around 9 percent. This is essential if economic diversification is to continue with a view of creating employment opportunities for the rapidly growing labour force. Bringing inflation down and maintaining a stable real exchange rate will, therefore, remain central to the Bank's objectives.

Maintaining an acceptable rate of growth of credit will be one of the intermediate objectives of monetary policy. The Bank of Botswana will, therefore, continue to closely monitor credit to the non-mining, non-government sectors, so that corrective measures could be taken in good time to ensure that credit does not grow at levels that could exacerbate inflationary pressures. The Bank continues to work closely with Government to ensure that public expenditure is kept within levels which do not undermine the attainment of low and stable inflation.

As in the past, the Bank will use the Bank Rate and Open Market Operations to maintain real interest rates at an appropriate level in order to keep inflation within a range that is conducive to stable economic growth and that contributes towards the maintenance of macroeconomic balance.

In the second half of 1998, the Bank tightened monetary policy in the wake of emerging inflationary pressures. Adjustment to interest rates in 1999 will depend on inflationary developments.

Conclusion and Summary

The overriding goal of monetary policy in 1999 will be to continue to reduce inflation and keep it at a level which will help promote macroeconomic balance and stable growth, while also helping to maintain Botswana's competitiveness.

In order to achieve the stated objectives, there will be a greater need for both monetary and fiscal policies to complement each other in the fight against a common enemy - inflation.