MONETARY POLICY STATEMENT - 2001

by

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INTRODUCTION

It is now an established tradition for the Bank of Botswana to publicly issue an annual Monetary Policy Statement at this time of the year. This is done with a view to providing a framework within which monetary policy will be developed and implemented during the year, thereby assisting the public in making informed investment decisions.

When the 2000 Statement was presented, the Bank was concerned about spiralling inflation that had begun in 1999. Accordingly, the Bank took strong measures during 1999 and 2000 to slow down the rate of increase in private expenditure, as reflected in the rapid expansion of borrowing from the banking system.

In doing so, it was the Bank's belief that the measures taken to slow down the rate of increase in expenditure, particularly through borrowing from the banking system, would reduce the level of inflation and dampen inflationary expectations. Furthermore, when designing anti-inflation policy measures, the Bank had to strike a balance between the need to contain inflation and to avoid an undesirable sharp slowdown in economic growth. The fight against inflation was also aimed at the need to maintain the competitiveness of Botswana's exports, and to encourage domestic financial saving by ensuring that deposit interest rates are positive in real terms.

At this time last year, when the 2000 Monetary Policy Statement was presented, there was hope that inflation would decline during the year. In the event, inflation rose, averaging 8.6 percent in 2000, compared to 7.8 percent in 1999. The rise in inflation was due to a number of factors - higher inflation in Botswana's trading partner countries and the sharp increase in international oil prices - which led to an increase in imported inflation. In fact, higher inflation was a global phenomenon in 2000. Imported inflationary pressures were exacerbated by increases in some domestic administered prices. In contrast to previous years, however, demand-related inflationary pressures declined, with reduced growth rates of both credit and Government spending. Nevertheless, the rate of expansion in expenditure was still high.

In the face of rising inflation and concerns about inflationary expectations, monetary policy necessarily remained tight during the year, and there was no scope for any reduction in nominal interest rates. However, while the objective of lower inflation remained elusive, the Bank broadly succeeded in maintaining positive real interest rates that were comparable with those in major trading partner countries. On the competitiveness front, there were mixed developments during the year. Producers competing in world markets benefited from the depreciation of the Pula against the US dollar and other major currencies, while those competing with South African products faced the challenge of the appreciation of the Pula against the South African rand as this represented a deterioration in the competitiveness of Botswana products vis-à-vis those of South Africa.

This year, the objective of monetary policy is to substantially reduce inflation from the 2000 average of 8.6 percent. The desired lower inflation is essential if Botswana exporters are to remain competitive. Moreover, if achieved, lower inflation would permit an eventual reduction in the cost of borrowing.

The desired reduction of inflation will require that the momentum of the expenditure restraint measures that were put in place in 2000, especially the importance of dampening inflationary expectations, should be sustained this year. In this regard, it is essential that the growth of credit to the private sector is contained at sustainable levels. It is also hoped that the restraint in public expenditure that has been evident in recent years, and was supportive of and complementary to the anti-inflationary monetary policy stance, will be maintained in 2001.

Before outlining the Bank's Monetary Policy for 2001, it is important to briefly review economic performance and monetary policy operations in 2000, as background to this year's monetary policy stance.

BOTSWANA'S ECONOMIC AND FINANCIAL PERFORMANCE IN 2000

Economic Performance

The year 2000 was good for economic growth internationally, with the rate of expansion in the world economy rising from 3.4 percent in 1999 to an estimated 4.7 percent in 2000. Faster growth was experienced in all regions of the world.

Botswana's rate of economic growth rebounded to 7.7 percent in 1999/2000, after a relatively slow growth of 4.1 percent in 1998/99. The recovery was mostly due to a sharp increase in diamond production with the coming on stream of the Orapa 2000 project. As a result, mining output rose by 11.9 percent over the previous year and this resulted in an increase in the foreign exchange reserves by 17 percent to P33.9 billion (USD6.3 billion) in December 2000, which was equivalent to 34 months of imports of goods and services. The non-mining sector, however, did less well, with growth slowing down from 7.8 percent to 5.7 percent. The manufacturing, construction and agriculture sub-sectors experienced particularly sharp declines in their growth rates. Nevertheless, Botswana's overall growth performance was rapid by international standards.

Monetary and Credit Developments

There were welcome developments in the growth rates of money and credit during 2000.

All the key measures of money supply (M1, M2, M3 and M4) grew at sustainable rates during the year compared to 1999.

Moreover, the rate of increase in total commercial bank lending steadily declined during the year; it was 17.6 percent in the year to December 2000, compared to 41.4 percent at the end of 1999. This welcome reduction in credit growth was mainly in response to the increase in lending interest rates resulting from monetary policy actions. Credit to the household sector rose by 20 percent in 2000, down from 45 percent in December 1999, while credit to the business sector grew by 14 percent in 2000, compared to 41 percent in 1999. Despite the considerable reduction in credit growth, the overall rate of increase in bank lending was still in excess of the desired rate.

Fiscal Developments

The Monetary Policy Statement for 2000 anticipated a continued slowdown in Government spending. In the event, Government expenditure during the calendar year 2000 was only 4.9 percent higher than in 1999. Generally, therefore, the thrust of fiscal policy has been in the desired direction. Revised estimates for the 2000/2001 fiscal year, which were presented in the 2001/2002 Budget, indicate that year-on-year expenditure growth is projected at 14 percent, compared to 15 percent in the previous year.

Nominal and Real Exchange Rates

Nominal exchange rates showed considerable volatility during 2000. The South African rand depreciated by 19 percent against the US dollar and by 12 percent against the Euro. The extent of this depreciation was much greater than expected at the beginning of the year, and appears to be due to a variety of factors, including adverse political developments in parts of the region and concerns about the performance of the capital account of South Africa's balance of payments. It was in this context that the Pula depreciated by 14 percent against the US dollar and 6 percent against the Euro during the year, while appreciating by 6 percent against the South African rand.

In real terms (when relative inflation with trading partner countries is taken into account), the Pula appreciated by 6.2 percent against the South African rand. However, higher inflation in Botswana than in the USA was more than offset by nominal exchange rate depreciation. As a result, the Pula depreciated in real terms by 9.2 percent against the US dollar and 0.8 percent against the Euro.

Inflation

The consumer price index data for the period January 1999 to August 2000 were revised during the year[1]. As a result, average inflation for 1999 was 7.8 percent, which was higher than was previously the case. On the basis of the revised price series, inflation accelerated in 2000 to an average of 8.6 percent, with a peak of 10.6 percent in July 2000.

Higher inflation was driven by prices of imports in the main, especially by the rise in oil prices, which led to a 23 percent increase in the cost of fuel and power and a 15 percent increase in the cost of transport. The impact of higher world oil prices was worsened by the sharp depreciation of the Pula against the US dollar during the year. The rise in the cost of imports accelerated from 7.9 percent at the end of 1999 to 8.8 percent in December 2000. Inflation in South Africa[2], Botswana's main source of imports, rose from 7.9 percent in 1999 to 8.3 percent in 2000.

Domestic inflation was also driven by a 15.5 percent increase in housing costs, due largely to an increase in rentals charged by the Botswana Housing Corporation. However, food prices, which comprise the largest component of the consumer price basket of goods, rose by only 4.1 percent, compared to an increase of 5.3 percent in 1999. Prices of domestically produced goods rose by 6.3 percent in 2000, compared to 6.7 percent in 1999, while prices of non-tradeables rose by 9.9 percent, against 12 percent in 1999. The reduction in the domestic component of inflation was consistent with the slowdown in domestic expenditure due to the decline in growth rates of both credit and Government spending.

Monetary Policy Implementation in 2000

In view of rising inflation and the undesirably high rate of credit growth, monetary policy remained restrictive throughout the year. The Bank Rate was raised twice, by 50 basis points each time, from 13.25 percent to 13.75 percent in February 2000, and to 14.25 percent in October 2000. Correspondingly, commercial banks increased their lending and deposit interest rates, although deposit interest rates were increased by smaller margins than lending interest rates. Apart from increases in the Bank Rate, the Bank continued to manage the liquidity of the banking system through open market operations, supplemented by the use of repurchase agreements and the secured lending facility.

The combined effect of the deployment of monetary policy tools was that the yield on 3-month Bank of Botswana Certificates (BoBCs) rose from 12.0 percent at the end of 1999 to 12.7 percent at the end of 2000, and excess liquidity of the banking system declined by 4.8 percent in 2000,[3] contrasting with an increase of 20.7 percent in 1999. Real interest rates on 3-month BoBCs rose from 3.3 percent in December 1999 to 3.7 percent in December 2000. The rates were higher than comparable real interest rates in South Africa, the USA and the UK, which were 3.0 percent, 2.5 percent and 2.7 percent, respectively.

Despite the increase in inflation during 2000, it should not be concluded that monetary policy was unsuccessful. The growth rate of credit, the Bank's key intermediate target variable, was sharply reduced; and when combined with reduced growth in Government spending, this indicated that domestic demand pressures on inflation were on a downward trend. The rise in headline inflation was largely due to supply-side cost pressures, including international oil prices, exchange rate changes against major international currencies and domestic rentals, all of which are largely outside the influence of monetary policy.

ECONOMIC AND FINANCIAL PROSPECTS FOR 2001

Economic Prospects

Expectations are that global economic activity will slow down in 2001 compared to 2000, particularly in the USA, where it appears the economic boom that lasted for most of the 1990s has finally come to an end. The anticipated slowdown in the world's largest economy, USA, will have an impact on the rest of the world economy.

Despite the projected slowdown in world economic growth, the Botswana economy is forecast to maintain a reasonably high rate of growth of around 8-9 percent in 2000/2001. This will be due, in large part, to the full impact of the Orapa Mine expansion on mining sector output, combined with some recovery in the non-mining sector, especially in manufacturing, transport and construction. However, following completion of the Orapa Mine expansion, there is likely to be a deceleration in the rate of growth.

Inflation Outlook in 2001

While inflation rose worldwide in 2000 in response to higher energy prices, it is forecast to decline in 2001 in most advanced economies. The expectation of lower inflation reflects forecasts of lower economic growth for the global economy, a factor which would weaken demand. Moreover, despite uncertainties with regard to the volumes of supply, oil prices are anticipated to decline from current levels. For major industrial countries, inflation is forecast to decline from 2.5 percent at the end of 2000 to 1.9 percent in 2001. In South Africa, it is expected that monetary policy restraint will continue and this, together with the anticipated fall in oil prices, is expected to reduce core inflation to 7.5 percent or below.

MONETARY POLICY FOR 2001

Domestically, there remains a pressing need to bring down inflation. While the ultimate objective is to achieve a level of inflation that would be comparable with that of industrialised economies, a more immediate objective should, at least, be to achieve inflation that is no higher than that of developing countries as a whole.

While this objective is ambitious, it is achievable. The external environment is benign, in view of the expected decline in global inflation and the likelihood that average oil prices will be lower in 2001 than in 2000. It is also likely that imported inflationary pressures from South Africa will be partially offset by the impact of the appreciation of the Pula against the South African rand that has already taken place but is yet to feed through to Botswana inflation.

Even with favourable prospects with respect to external inflationary developments, achieving lower inflation will depend on containing and reducing domestic inflationary pressures. It will, therefore, be necessary to continue the trend of slower domestic public and private expenditure growth that began in 2000. The desired reduction in inflation implies a further decline in credit growth during 2001, from 17.6 percent registered at the end of 2000. A lower rate of credit expansion will still accommodate the need to finance the real growth of the non-mining sector, and foster a successful diversification of the economy. This effort needs to be complemented by continued restraint in the growth of public expenditure to below the rate of 14 percent estimated for the 2000/2001 fiscal year.

A substantial balance of payments surplus is projected for 2001, as a result of which the foreign exchange reserves should continue to grow and add liquidity to the banking system. This situation will be compounded by the projected 2001/2002 Government budget deficit. Therefore, the Bank will continue to manage interest rates and liquidity in the financial sector in a manner consistent with the objective of reigning in inflation. Liquidity management will continue to rely on open market operations using Bank of Botswana Certificates. The task will also be facilitated by measures aimed at improving the functioning and efficacy of the money market.

CONCLUSION

Internationally, there are prospects of lower economic growth and reduced inflation which have already given rise to cuts in interest rates in major industrialised economies, led by the USA with the two 50 basis point reductions in January 2001. However, domestically, the economy will expand at a relatively high rate in 2001/2002. When economic expansion is high, there is always a risk of expenditure growth rising at unsustainable rates that lead to inflationary developments. Therefore, even though the Bank is sensitive to the need to ease monetary policy, it is essential that any reduction in interest rates should not be premature.

As pointed out in past years' Monetary Policy Statements, the main objectives of Botswana's monetary policy are to achieve price stability and to maintain positive real interest rates at comparable levels to those of major international financial markets. It goes without saying, therefore, that when macroeconomic conditions are right, the Bank will be in a position to reduce interest rates. In this respect, the substantial decline in credit growth in the course of 2000 is a positive development. However, the opportunity for reducing interest rates will only be presented when there is clear evidence that overall domestic expenditure trends are appropriate, and inflation is on a definite downward trend.

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1 The revisions were backdated to 1999 due to the fact that the increase in Botswana Housing Corporation rentals, effected in 1999, had not been factored into the consumer price index for that year.

2 Reference to South African inflation is to core inflation (i.e. the change in the overall consumer price index excluding prices of certain food products, interest rates on mortgage bonds, overdrafts and personal loans, value-added tax and property taxes) unless otherwise stated.

3 December 1999 to October 2000 growth rate.

February 27, 2001