MONETARY POLICY STATEMENT 2002

By

Linah K Mohohlo
Governor, Bank of Botswana

February 20, 2002

17938 Khama Crescent, Gaborone; Tel: (267) 360-6000; Cables: BotBank; Telex: 2448 BD/2405 BD
Website: www.bankofbotswana.bw

BANK OF BOTSWANA

MONETARY POLICY STATEMENT - 2002

1. INTRODUCTION

1.1 For a number of years now, the Bank has used the annual Monetary Policy Statement to report on inflation and monetary policy developments in the previous year and to provide an assessment of the prospects for inflation for the year ahead. The annual Statements have been supplemented by mid-year reviews, highlighting progress made in the first half of the year in meeting the objectives and updating forecasts and analysis relating to the remaining six months. The 2002 Monetary Policy Statement builds upon this approach.

1.2 As in the past, the current Statement reviews recent developments in inflation and monetary policy and presents the Bank's analysis and policy position for the coming year. It also includes a section on the framework used by the Bank in the formulation of monetary policy, as well as the Bank's explicit annual objectives for inflation and credit growth, and an explanation of how these are derived.

2. THE BANK'S MONETARY POLICY FRAMEWORK AND OBJECTIVES

2.1 The principal objective of monetary policy in Botswana is the achievement of sustainable low inflation. The control of inflation is the means by which monetary policy contributes, along with other Government policies, to the ultimate national objective of a stable macroeconomic environment and sustainable rates of growth of incomes and living standards.

2.2 The Bank pursues its monetary policy objective in support of the broader national objectives of economic diversification and export competitiveness. The control of inflation helps Botswana generally to maintain competitiveness, but the Bank seeks specifically to achieve a rate of inflation that, at a minimum, will maintain relative stability in the real exchange rate and avoid the need for a devaluation of the Pula. Given an exchange rate policy that aims to keep the nominal effective exchange rate of the Pula constant[1], this yields the Bank's annual inflation objective, which is described more fully in Section 7 below.

2.3 The main tool of monetary policy used by the Bank to achieve its inflation objective is the level of interest rates. Changes in interest rates, along with other factors such as the exchange rate, balance of payments, and the Government's fiscal policy, affect the overall level of demand for goods and services in the economy. The Bank, therefore, has its main influence on inflationary pressures in the

[1] Specifically, the policy is to peg the value of the Pula to a basket of currencies comprising the South African rand and the International Monetary Fund's Special Drawing Right (SDR), in proportions that broadly reflect Botswana's trade patterns.

economy indirectly through its influence on domestic demand relative to a given level of national output.

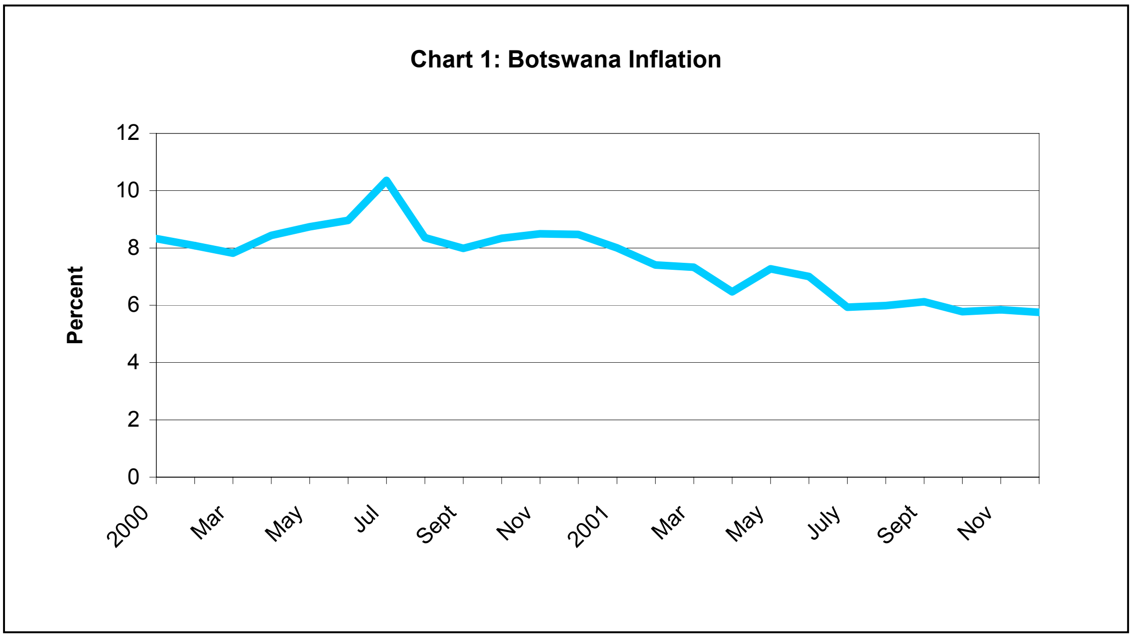
2.4 *In pursuing sustainable low inflation, the Bank is mindful of the negative consequences that an overly tight monetary policy can have for economic activity generally, and employment and investment in particular. Therefore, in its use of interest rates to restrain inflation, the Bank aims to balance the needs of savers and investors by keeping real interest rates high enough to provide a positive return to savers but not allowing them to be so high that they significantly discourage private sector borrowing to finance viable investment projects. In this regard, the Bank seeks generally to maintain real interest rates in Botswana at levels that are comparable to those prevailing in international capital markets; deviations from these rates will be for the purpose of moderating inflationary or deflationary pressures arising from domestic demand.*

2.5 *To implement policy, the Bank focuses on intermediate targets which influence the main components of domestic demand. The principal intermediate target in the current policy framework is the rate of growth of credit to the private sector, since it is considered an important contributor to the growth of private consumption and investment and, importantly, can be directly influenced by monetary policy through interest rates. The factors considered in establishing the Bank's monitoring range for credit growth, and the specific range for 2002, are also described more fully in Section 7 below. The rate of growth of Government spending is also an important indicator of domestic demand, given that a large proportion of this demand is derived from expenditure on public consumption and investment. This continuing large role of the Government in the economy underscores the need for complementarity between fiscal and monetary policy. Other indicators besides credit growth and Government expenditure that the Bank considers when assessing the overall stance of its policy are measures of external demand and cost pressures, and indicators of domestic cost pressures, such as wage growth, productivity and capacity growth.*

3. DEVELOPMENTS IN INFLATION IN 2001

3.1 *It was within the policy framework described above that the 2001 Monetary Policy Statement specified the Bank's objective of achieving a reduction in inflation from the increased levels that had been seen during 2000. This inflation objective was presented in the context of an international environment that was experiencing increased inflation, and a domestic environment that was characterised by excessive demand pressures, particularly those arising from high rates of credit growth. However, it was expected that the international environment would be benign during the year, with lower inflation anticipated, and that monetary policy measures already in place would contribute towards reduced inflationary pressures arising from domestic demand.*

3.2 *In the event, inflation in Botswana continued to ease in 2001 (Chart 1), reaching 5.8 percent by the end of the year, compared to 8.5 percent at the end of 2000. Average inflation for 2001, at 6.6 percent, was also well below the 8.5 percent average for the previous year. The 5.8 percent inflation rate that prevailed during* *the last three months of 2001 was the lowest since February 1985, when it was 5.4 percent. As described in more detail below, the decline in inflation mostly reflected low inflation and weak demand globally, and lower international oil prices. Domestic demand pressures on inflation were, however, comparable with those in 2000, as reflected by the growth rates of credit to the private sector and government spending. Inflation was also affected by technical factors relating to domestic administered prices, especially public sector housing rentals; the impact of overlapping rental adjustments by the Botswana Housing Corporation (BHC) in July 2000 and May 2001 pushed up inflation in the middle of the year, but also led*



to a sharp decline in inflation from July onwards when this factor fell out of the consumer price index.

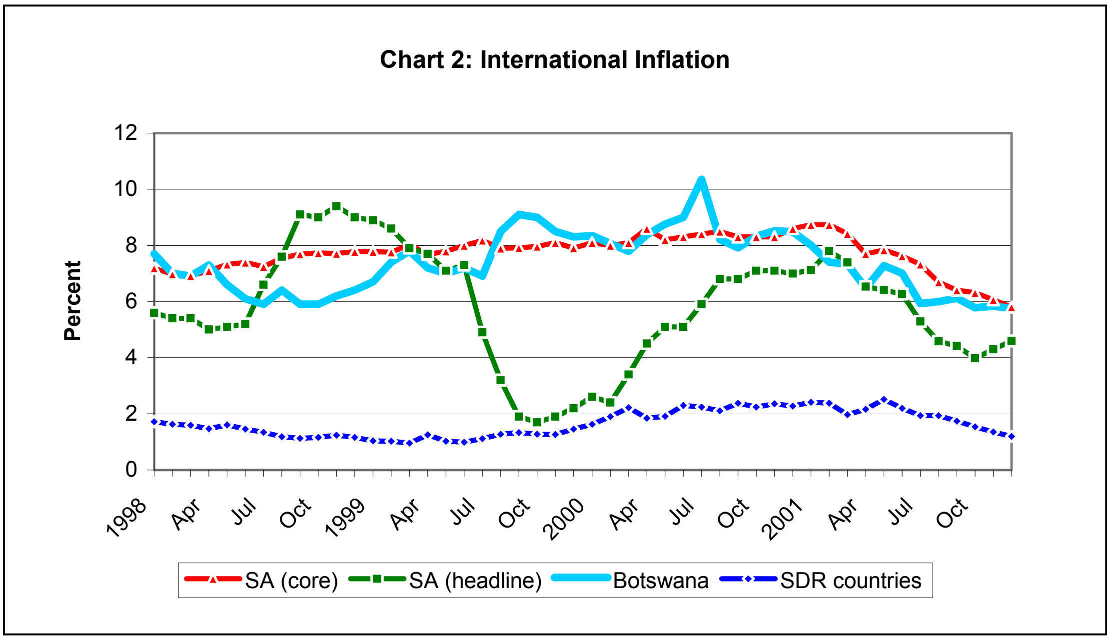
3.3 Price increases for most commodity groups declined during the year. The most dramatic reductions were in respect of fuel and power, where year-on-year inflation fell from 22.5 percent in 2000 to 3.0 percent in 2001, and transport costs, where inflation fell from 15.4 percent to 4.8 percent. A few commodity groups experienced higher inflation during 2001 (clothing and footwear, and education), but the overall impact of these increases was small.

3.4 The lower inflation in 2001 compared to 2000 were also apparent in respect of goods and services classified by tradeability. Inflation for non-tradeables fell from 9.1 percent in December 2000 to 7.7 percent in December 2001, while tradeables inflation also slowed down, from 7.9 percent to 5.1 percent. Lower tradeables inflation was mostly due to the reduction in the annual rate of increase in the cost of imported tradeables, which fell from 8.8 percent in 2000 to 4.6 percent in 2001, due largely to lower global inflation and possibly to the modest nominal appreciation of the Pula. Domestic tradeables inflation only fell slightly, from 6.3 percent in 2000 to 5.9 percent in 2001; this slow rate of decline most likely reflects the impact on incomes, and hence spending, of public sector salary and wage increases during the year, combined with changes in administered prices, especially rentals and water tariffs.

4. ***INFLUENCES ON DOMESTIC INFLATION***

(a) ***International Developments***

4.1 *Globally, inflation was lower in 2001 compared to 2000 (Chart 2), reflecting the global economic slowdown and subdued demand, which was aggravated by the terrorist attacks of September 11, 2001 in the United States of America. Overall inflation in the advanced economies was 1.2 percent in 2001, considerably lower than the 2.5 percent in 2000[2]. Inflation in the U.S. fell particularly sharply, from 3.4 percent in 2000 to 1.6 percent in December 2001. South African inflation also fell significantly; core inflation was 5.8 percent in December, compared to 8.6 percent at the end of 2000.*

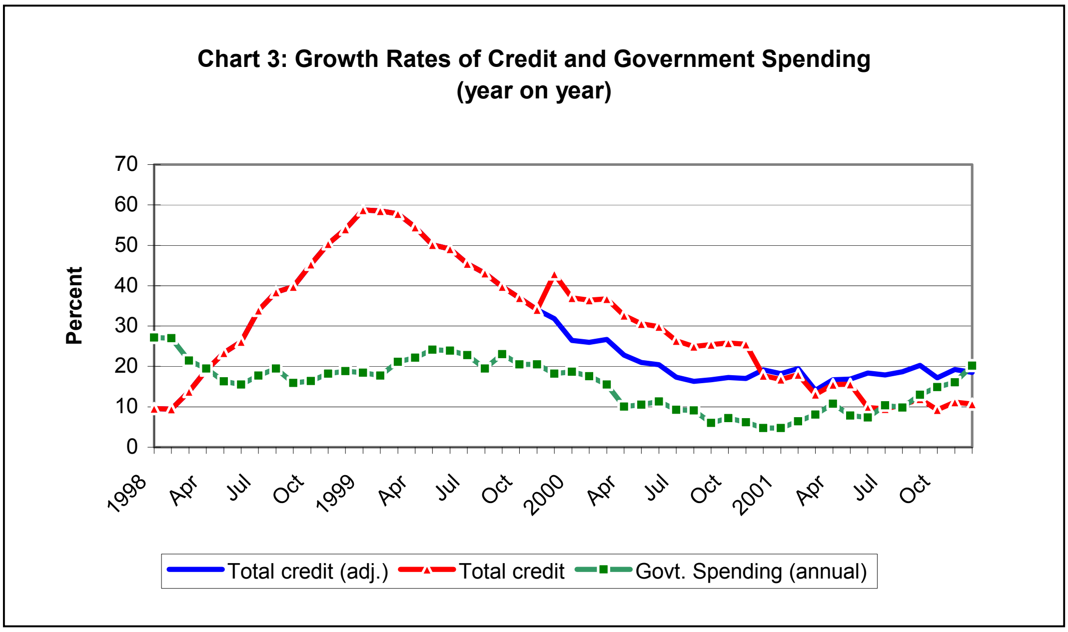


(b) ***Aggregate Demand***

4.2 *The growth rate of credit extended by the commercial banks slowed down in 2001, with average annual growth of 13.2 percent compared to 28.4 percent in 2000. By the end of 2001, the year-on-year rate of credit expansion was 10.7 percent, down from 17.7 percent at the end of 2000. However, these figures understate the underlying trend rate because of the impact of the extension and subsequent early repayment of loans, using offshore funds, by certain large borrowers. As can be seen in Chart 3, if these loans are excluded, credit growth did not slow down significantly in 2001; it remained between 15 percent and 20 percent during the year.*

4.3 *The annual growth rate of Government spending averaged 11 percent during 2001, similar to the average for 2000. However, towards the end of the year the growth rate picked up sharply, indicating potential emerging demand and inflationary pressures arising from the Government budget.*

2 Calculated as an average of inflation rates in the USA, UK, euro zone and Japan, using SDR basket weights.



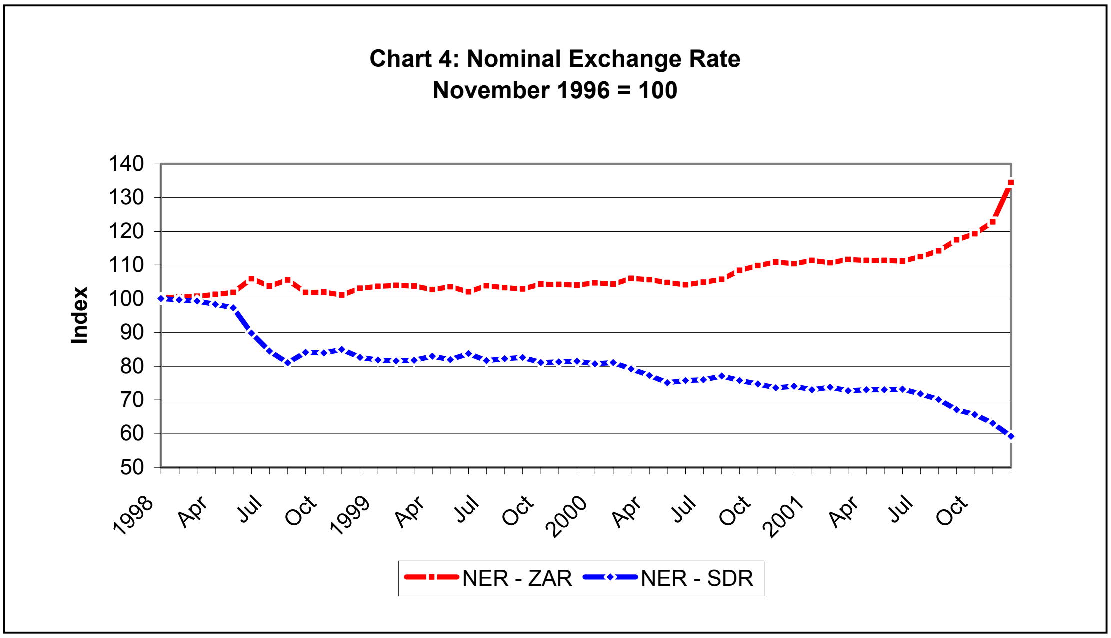
4.4 *Economic growth for the period 2000/2001 (July-June) was 9.1 percent, marginally higher than the 8.1 percent recorded during the previous national accounts year (1999/2000). However, this was largely the result of a very large increase (19.6 percent) in mining output, which in turn reflected the impact of the completion of the Orapa 2000 expansion project on diamond production. Economic growth excluding mining and Government in 2000/01 was only 3.0 percent, a sharp reduction from 6.2 percent in 1999/2000, indicating a considerable economic slowdown in the non-mining private sector. The GDP figures suggest, therefore, that aggregate demand is growing more slowly than the picture presented by the credit growth and Government spending indicators.*

(c) Nominal and Real Exchange Rates

4.5 *The main development with regard to exchange rates during 2001 was the rapid depreciation of the South African rand against major international currencies; over the year as a whole, the rand depreciated by 34 percent against the SDR. As a result of the link to the rand through the currency basket, the Pula also depreciated against major international currencies, losing 20 percent of its value against the SDR during the year*[3]*. However, the Pula appreciated markedly against the rand, gaining 22 percent over the same period. A number of factors have been identified as contributing to rand volatility; they include political and economic problems in Zimbabwe, the slow pace of the South African privatisation programme, industrial unrest as well as adverse investor sentiments in respect of emerging markets, which were accentuated by debt repayment problems in Argentina.*

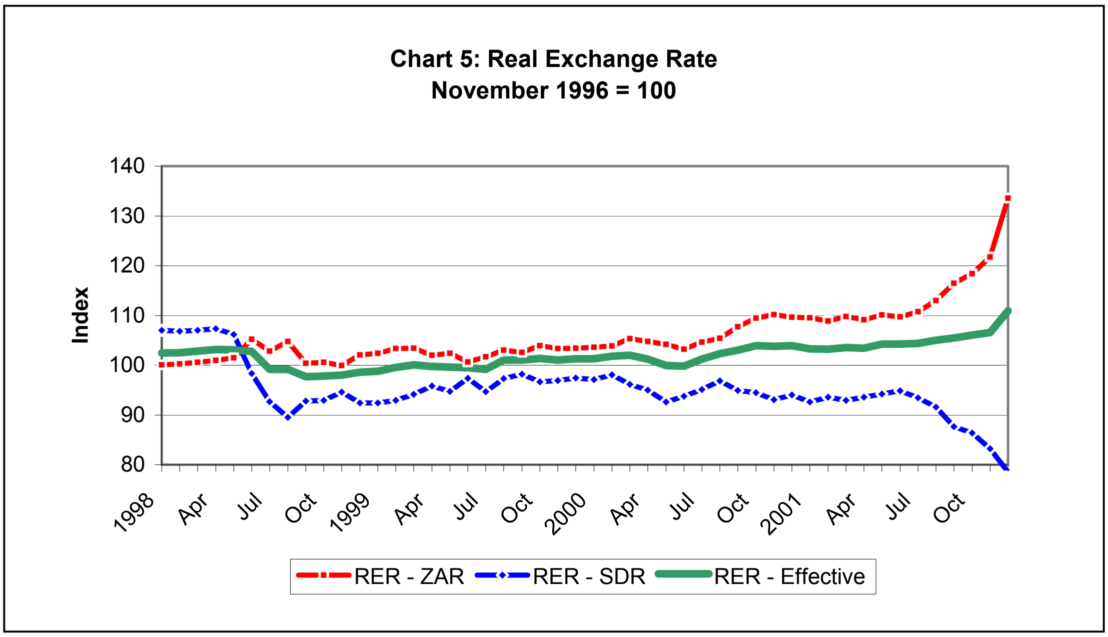
4.6 *In nominal effective terms, the Pula was relatively stable for most of the year (Chart 4). However, volatility in bilateral rates, particularly towards the end of the year, caused the Pula to appreciate in effective terms, for technical reasons, and by*

3 The Pula depreciated by 23 percent against the US dollar, 21 percent against the pound sterling, 19 percent against the euro and 11 percent against the Japanese yen during 2001.



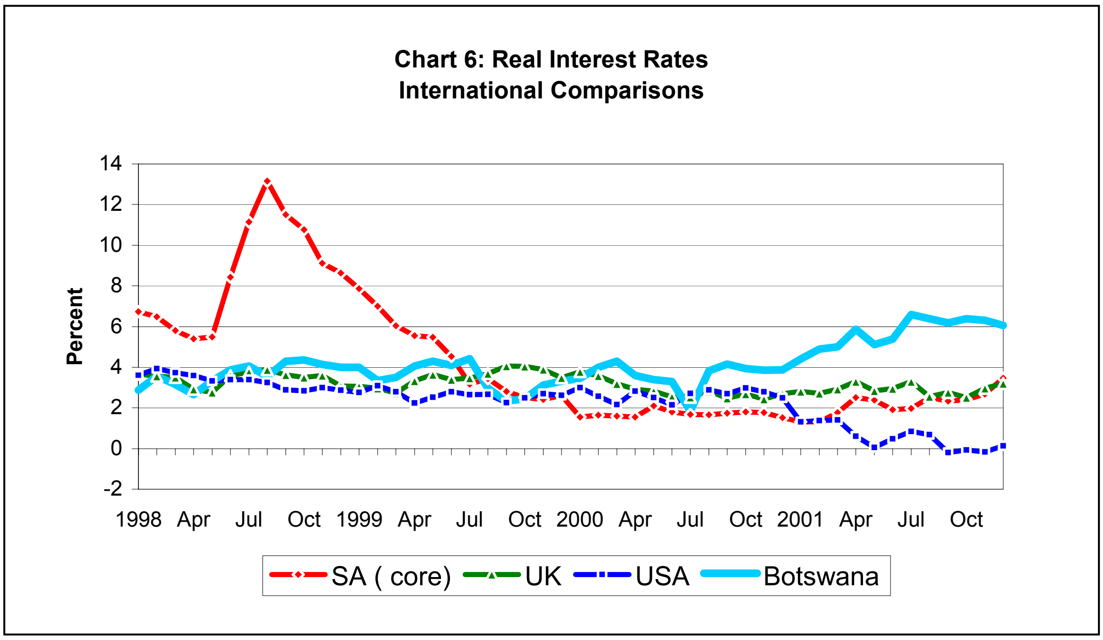
the end of the year the nominal effective exchange rate (NEER) of the Pula was 5.1 percent higher than at the end of 2000.

4.7 *The real effective exchange rate of the Pula appreciated by 6.8 percent during 2001 (Chart 5). Most of this reflected the appreciation of the nominal effective exchange rate over this period, with the remainder reflecting higher inflation in Botswana compared to trading partner countries.*



5. *MONETARY POLICY IMPLEMENTATION DURING 2001*

5.1 *In the 2001 Monetary Policy Statement, the Bank stressed the need to maintain the momentum of the downward trend in credit expansion by staying the course with respect to interest rates until such time that there was clear evidence that* *inflationary pressures had abated. Apart from a temporary increase in mid-year due to BHC rental increases, inflation declined through the year, and in the last three months fell to 5.8 percent. However, monetary policy remained restrictive, reflecting the fact that the reduction in inflation had not been sustained for a long enough time and had come largely from lower imported inflation. There were also concerns about incipient demand pressures, as the growth rates of both credit and Government expenditure were at undesirably high levels by the end of the year, and disposable incomes had risen sharply due to public sector wage and salary increases and an effective tax cut from an increase in the income tax threshold. It was considered that these developments added to the risk of a reversal of the recent decline in inflation, especially if monetary policy was eased.*



5.2 *Open market operations were conducted during the year to ensure that yields on BoBCs were consistent with the policy stance. The three-month BoBC rate ranged between 12.5 percent and 12.9 percent during the year. This reflects the unchanged policy stance since October 2000 (the Bank Rate has been maintained at 14.25 percent), although the lower rates on BoBCs in the latter half of the year may indicate market expectations of lower interest rates. BoBCs outstanding rose by 39 percent, from P3 712 million to P5 148 million, mainly as a result of the need to absorb liquidity arising from the growth of the net foreign exchange reserves[4] (P4 831 million) over and above the growth of Government deposits at the Bank (P3 662 million).*

5.3 *While there was little variation in nominal interest rates, Botswana's real interest rates rose during 2001, due to lower inflation (Chart 6). As at the end of the year, the real three-month BoBC rate was 6.1 percent, compared to 3.9 percent at the end of 2000. This contrasts with the downward trend in real interest rates in the major economies, resulting mainly from monetary policy easing. However,*

---

4 Change in the foreign exchange reserves net of revaluation gains attributable to the Bank of Botswana.

comparable South African real interest rates rose from 1.5 percent to 3.5 percent in 2001, due to the reduction in inflation.

6. OUTLOOK FOR INFLATION IN 2002

6.1 Globally, consumer demand and business confidence remain subdued while economic growth is weak, contributing to reduced global inflation. There is, however, uncertainty with respect to oil prices, which have been considerably lower since the terrorist attacks of September 11, 2001 in the USA. The recent agreement by OPEC members to reduce production, and indications that many non-OPEC members will follow suit, suggests that there may be an increase in oil prices in 2002.

6.2 Inflation in South Africa, which is the most important external influence on Botswana inflation, has declined. This favourable trend in inflation could reverse, however, if as is widely expected, South African import prices rise in response to the depreciation of the rand against major international currencies late in 2001. At the moment, core inflation in South Africa is forecast to rise to 6.8 percent by mid-year and average 7.2 percent for 2002 as a whole. In contrast, inflation in the major industrial countries is forecast to average 1.2 percent in 2002, similar to the 2001 figure. If the nominal effective exchange rate of the Pula remains unchanged, this would suggest that imported inflation in Botswana in 2002 is likely to be slightly higher, on average, than it was in 2001.

6.3 Domestically, there are mixed indications as to demand pressures. Export demand is likely to remain subdued due to low rates of global economic growth and, possibly, the impact of the nominal appreciation of the Pula in 2001, with the latter causing some switching from domestic to import demand. This may alleviate some of the pressure from credit growth that would otherwise spill over to growth in domestic demand. Nevertheless, underlying credit growth remains undesirably high and Government expenditure growth began to accelerate in 2001 compared to the previous year. The 2002 Government Budget indicates that this trend is likely to continue, with Government spending projected to rise sharply, by 27 percent, in the 2002/03 fiscal year, although, due to implementation constraints, actual spending growth may well be lower than this. Nonetheless, there are likely to be considerable inflationary pressures arising from the Government budget.

6.5 As in the past, adjustments in administered prices will have an impact on inflation. Whether or not fuel prices are increased will depend upon the combination of price developments in international markets and exchange rate developments; while oil prices fell sharply in US dollar terms in the last three months of 2001, the depreciation of the Pula against the US dollar has worked against this. Any upward adjustment in domestic fuel prices would have an additional impact if transport fares were increased as a result, as well as filtering into other domestic prices in time. It is also likely that BHC will increase rentals in mid-2002. The introduction of Value Added Tax (VAT) in July 2002 is also likely to cause an increase in the price level, causing a one-off increase in inflation.

7. MONETARY POLICY STANCE IN 2002

7.1 On the basis of the Bank's assessment of currently available forecasts of inflation in South Africa and the SDR countries for 2002, the Botswana inflation rate necessary to achieve general stability in the real effective exchange rate would be in the range of 4-6 percent[5]. This inflation objective, which the Bank will seek to achieve over 2002, is expressed as a range to reflect the range of possible outcomes currently forecast for South Africa and the SDR countries. If inflation in these countries meets or exceeds the average of the forecasts, then inflation in Botswana will need to stay within the upper part of the range. Similarly, if the inflation outcomes in these countries throughout the year are tending to improve on the average expected rate, the Bank will aim to ensure that inflation in Botswana falls within the lower part of the range. In the 2002 mid-year review of monetary policy, the Bank will evaluate whether this inflation objective needs adjusting in light of inflation trends elsewhere.

7.2 The range for the growth rate of private credit that is considered to be compatible with achieving this inflation outcome is 12.5 – 14.5 percent. This range is calculated from the estimated long-run capacity growth (aggregate supply) of the non-mining sector of the economy, as presented in the current National Development Plan (NDP 8), and the desired inflation rate for the year, with an allowance for the process of financial deepening as the economy develops. It also assumes a neutral impact of Government spending on domestic demand.

8. SUMMARY AND CONCLUSIONS

8.1 As was detailed earlier in this Statement, there have been encouraging developments in the trend of inflation in Botswana over the past year. Inflation has remained relatively low or continued to decline in major industrialised economies and, most importantly for Botswana, in South Africa. As a result, imported inflation eased, contributing to the slowing in the overall rate of inflation in Botswana. Other prices have also eased but not to the same extent, due partly to increases in administered prices and partly because of pressures from domestic demand as indicated in the continuing high levels of credit growth and Government spending.

8.2 The general expectation for 2002 is that non-inflationary growth should resume in the major industrial economies - except perhaps in Japan - by the second half of the year, due in large part to the aggressive easing of monetary policy by the central banks in these countries during 2001.

8.3 The risks to this generally more positive outlook for inflation compared to a year ago come from both domestic and external factors. Domestically, the main threat to inflation is demand pressures arising from the projected sharp increase in Government spending in the 2002/03 fiscal year. Externally, if OPEC is successful

---

5 In view of the volatility of the standard measure of headline inflation, the Bank is in the process of reviewing possible measures of core inflation that would be suitable as indicators of underlying inflationary pressures and hence better suited to the purpose of guiding monetary policy. Several measures of core inflation show promise and are currently being evaluated for use by the Bank.

in cutting production and convincing non-OPEC countries to do the same, oil prices could rise more than what current consensus forecasts assume will be the case. There is also the distinct possibility that the impact of last year's depreciation of the rand on inflation in South Africa could be more than is currently expected. In the circumstances, the Bank will need to ensure that the resulting rise in domestic costs do not lead to a generalised rise in domestic inflation.

8.5 Looking ahead to 2002, the task for monetary policy more generally will be to ensure that the reduction in inflation that was achieved towards the end of 2001 is sustained. This will be helped if lower inflation contributes to expectations of reduced future inflation. In the short term, if the Bank is to meet its inflation objective of 4-6 percent, there remains a need for continued restraint in the growth of domestic demand, especially demand arising from underlying growth in domestic credit. The need to contain credit growth will be particularly acute in light of the announced increase in public expenditure.