BANK OF BOTSWANA

MONETARY POLICY STATEMENT – 2003

1. INTRODUCTION

1.1 The annual Monetary Policy Statement issued by the Bank of Botswana serves several purposes. First, it provides an opportunity for the Bank to report on inflation and monetary policy developments in the previous year, and to present its assessment of the outlook for inflation in the current year. Second, it enables the Bank to outline policy issues and the approach that will be taken in formulating its policy stance in response to inflation-related developments throughout the year. Third, since 2002, the Statement has contained the Bank's annual objectives for inflation and credit growth, and an explanation of how these were derived. The Monetary Policy Statement, therefore, plays an important role in conveying to stakeholders and the public at large a range of information relating to one of the Bank's core functions, the formulation and implementation of monetary policy. While the transparency entailed in the presentation of the Statement is important in its own right, it is also important in influencing economic and financial expectations and, therefore, the behaviour of economic agents. In this regard, the Bank's aim is to engender a public expectation of sustainable low inflation consistent with the broad objective of macroeconomic balance as a basis for sustainable growth.

1.2 Consistent with past practice, this year's Monetary Policy Statement reviews the trends in inflation and their underlying causes, and assesses the extent to which monetary policy succeeded in achieving its objectives in 2002. This is followed by a presentation of the Bank's analysis of prospective developments during 2003 and, based on that, the policy outlook for the current year. The Statement concludes that although developments in 2002 took inflation to over 11 percent, some way above the desired range of 4 - 6 percent for the year, this was largely due to exceptional transitory developments, especially the introduction of Value Added Tax (VAT), and that after discounting the impact of VAT, inflation was close to the upper end of the Bank's policy goal. In light of this, as well as the tightening of monetary policy towards the end of 2002 and the more restrained fiscal policy announced in the 2003 Budget, it is considered that there are good prospects of achieving a substantial reduction in inflation during 2003. The aim of monetary policy going forward will be to ensure that the reduction is consistent with the Bank's inflation objective for the year.

2. THE BANK'S MONETARY POLICY FRAMEWORK AND OBJECTIVES

2.1 The principal objective of monetary policy in Botswana is the control of inflation. Specifically, it is the achievement of a sustainable, low and predictable level of *inflation that will, among others, enable the maintenance of international competitiveness. In the context of an exchange rate policy that aims to keep the nominal effective exchange rate of the Pula stable, this implies that Botswana's inflation rate should, at a minimum, be no higher than the average inflation rate of its major trading partners, if stability of the real exchange rate is to be achieved. This yields the Bank's annual inflation objective, which is described in detail in Section 7 below.*

2.2 To achieve its inflation objective, the Bank uses interest rates to influence inflationary pressures in the economy. This is achieved indirectly through the impact of interest rates on credit and other components of domestic demand. 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, relative to a given level of output. Inflationary pressures are likely to emerge when expenditure grows at a faster rate than available goods and services.

2.3 In formulating its monetary policy stance, the Bank looks closely at the sources of any changes in inflation. In particular, the policy responds primarily to changes in inflation that are due to domestic demand pressures, rather than those that may be due to transitory factors or supply fluctuations on which monetary policy would have no direct influence. Therefore, in addition to headline inflation data published by the Central Statistics Office, the Bank also examines the underlying inflation trend, or core inflation, which excludes the impact of transitory factors and exceptional changes in administered prices and/or indirect taxes. The Bank, however, recognises the need to respond to any impact that these excluded items might have on underlying inflation through inflation expectations and second-round effects.

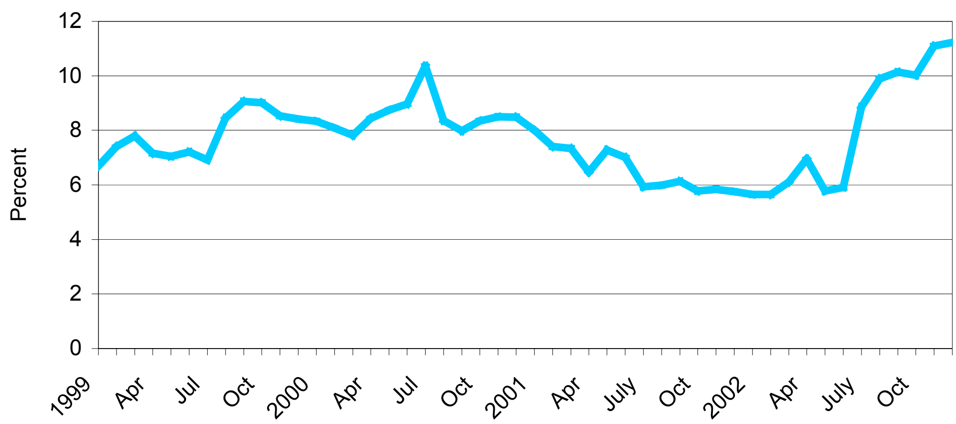
2.4 When implementing monetary policy, the Bank focuses on the intermediate targets that influence the main components of domestic demand. The principal intermediate target in the monetary policy framework is the rate of growth of commercial bank credit to the private sector, which is considered an important contributor to the growth of private consumption and investment and, importantly, can be directly influenced by monetary policy through interest rates. The rate of growth of Government spending is also an important determinant of domestic demand, since a large proportion of this demand is derived from expenditure on public consumption and investment. The continuing large role of the Government in the economy underscores the need for complementarity between fiscal and monetary policies in achieving the inflation objective.

3. DEVELOPMENTS IN INFLATION IN 2002

3.1 The 2002 Monetary Policy Statement specified the Bank's objective of achieving inflation during 2002 in the range of 4 - 6 percent. In determining the inflation objective, the Bank was guided by an outlook of stable global inflation as world economic activity remained subdued, albeit with higher growth rates compared to 2001. Throughout the year, the world's major central banks maintained loose monetary policy with the aim of stimulating economic activity. Given excess *capacity and the continuing credibility of monetary policy in these countries, inflation was largely controlled. In Botswana, however, domestic demand remained strong, with growth rates for both commercial bank credit and government expenditure higher than the desired rates indicated in the 2002 Monetary Policy Statement. In this context, it was considered that the existing tight monetary policy stance would contribute to a reduced rate of growth of credit, while the specification of the inflation objective and clear indications of the Bank's response to any inflationary developments were expected to anchor inflation expectations downwards.*

3.2 *Since the slowdown that began in the second half of 2000, annual inflation stabilised at around 6 percent in the first half of 2002, the upper end of the target range for the year (Chart 1). However, headline inflation rose from 5.9 percent in June to 11.2 percent in December[1], largely as a result of the introduction of VAT in July. For the whole of 2002, inflation averaged 8.1 percent, compared to 6.6 percent in 2001 and 8.5 percent in 2000.*

Chart 1: Botswana Inflation



3.3 *Following the introduction of the 10 percent VAT, it was anticipated that prices would rise in general by between 4 percent and 6 percent, over and above underlying inflation. The Bank indicated in a press release in June 2002 that any VAT-related price increases would be a one-off temporary adjustment, which in the absence of any significant second-round effects, would not result in a sustained rise in inflation. In the event, and in line with expectations, the month-on-month rate of change in prices rose from an average of 0.5 percent over the previous twelve months to 3.2 percent in July, and progressively slowed down in the subsequent months (1.2 percent in August, 0.6 percent in September and 0.4 percent in October), a clear indication of the one-off impact of VAT. Although some monthly price increases were higher in the last quarter of 2002, this was mostly due to*

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1 Unless otherwise indicated, inflation rates are shown as the year-on-year change for the period noted.

technical adjustments to components of the Consumer Price Index (CPI) basket[2]. Overall, although inflation increased sharply in the second half of the year, an analysis of the inflation trend that discounts the impact of VAT and price data adjustments suggests an underlying rate of between 6 percent and 7 percent for 2002, just above the upper end of the Bank's policy goal.

3.4 *Most categories of commodities experienced higher inflation in 2002 compared to 2001, which was to be expected given the wide-ranging impact of VAT. Food prices, however, rose much faster than those of most other commodities, due partly to drought conditions in the region. Food price inflation rose from 4.1 percent in December 2001 to 14.3 percent in December 2002; this increase alone accounted for almost half of the rise in overall inflation during the year. This reinforces the view that, after taking account of the impact of VAT and other exceptional factors such as food prices, underlying inflation was largely contained during 2002.*

3.5 *Inflation was also higher in 2002 compared to 2001 in respect of goods and services classified by tradeability. Prior to the introduction of VAT in July 2002, inflation for non-tradeables and imported tradeables had fallen, but thereafter it rose sharply. Inflation for non-tradeables fell to 6.9 percent in June 2002, from 7.7 percent in December 2001, but rose to 11.7 percent in December 2002. Inflation for imported tradeables fell to 3.8 percent in June 2002, from 4.6 percent in December 2001, rising to 8.2 percent in December 2002. In contrast, inflation for domestic tradeables showed a consistent and more rapid upward trend, reaching 15.2 percent in December 2002, from 8.2 percent in June 2002 and 5.9 percent in December 2001.*

4. INFLUENCES ON DOMESTIC INFLATION

4.1 *The international environment was characterised by moderately rising inflation in 2002 (Chart 2). Inflation in advanced economies rose from 1.2 percent in 2001 to 2 percent in 2002, as all major economies experienced higher inflation, mostly resulting from rising energy prices, especially oil. However, with economic growth remaining weak, albeit improving slightly, major world central banks maintained accommodative monetary policies to support growth, taking the view that inflationary pressures were not generally of concern and noting the existence of excess production capacity, restrained consumer demand and benign inflation expectations. In South Africa, inflation rose sharply in 2002, largely reflecting the effects of the depreciation of the rand towards the end of 2001, and increases in food prices and labour costs. Core inflation in South Africa was 12.2 percent in December 2002, considerably higher than the 5.8 percent at the end of December 2001. The combined effect of all of these developments was that average inflation across Botswana's trading partners rose from 4.2 percent at the end of 2001 to 8.6 percent at the end of 2002. Botswana inflation briefly fell below that of its trading partners in mid-year but ended the year higher, largely due to the impact of VAT.*

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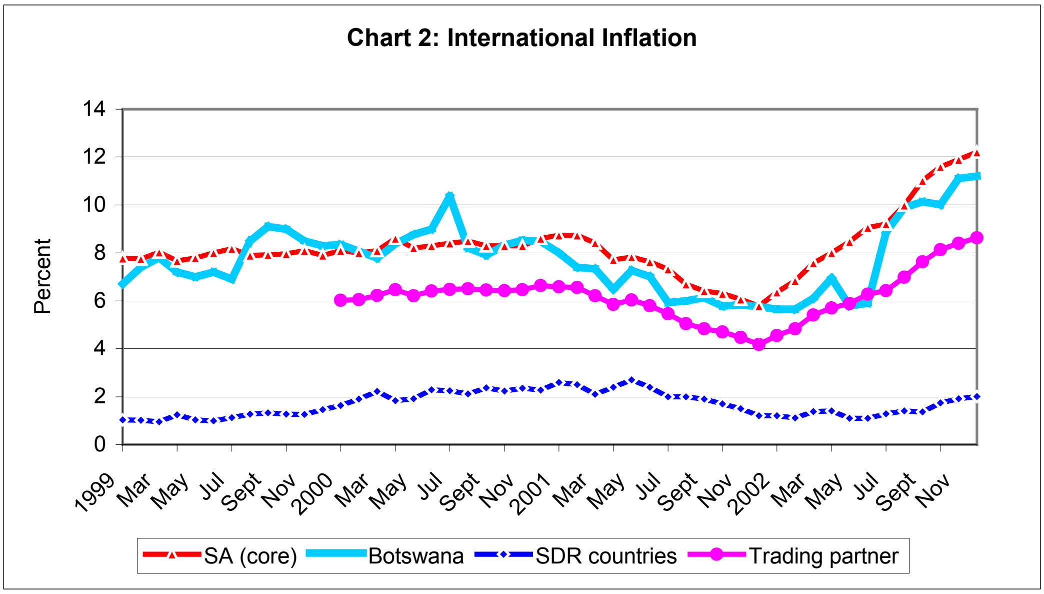
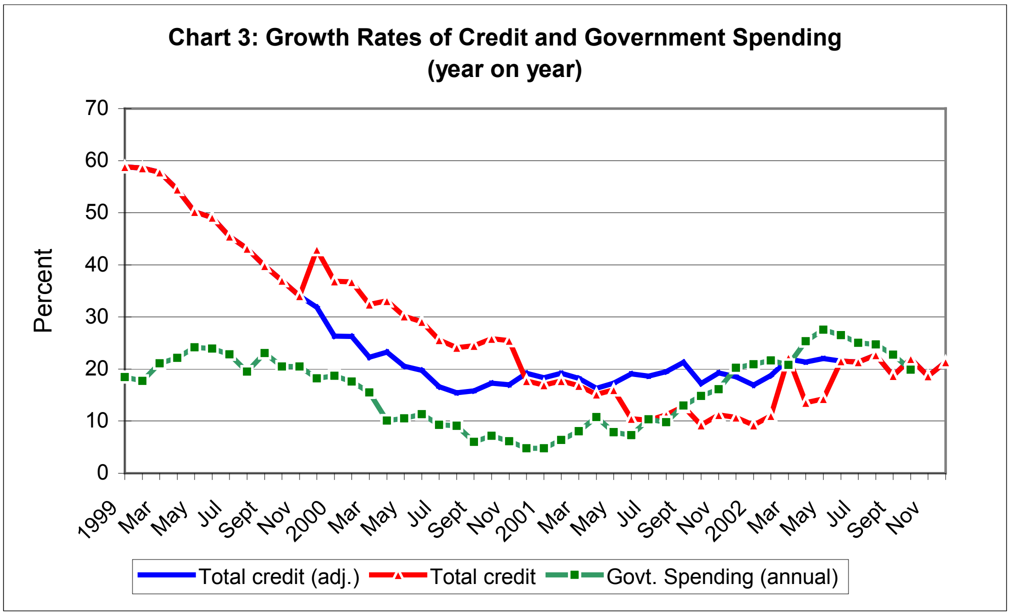
[2] Mainly the adoption of a new billing system by Botswana Telecommunications Corporation.



4.2 *Commercial bank credit to the private sector grew, on average, at an annual rate of 18 percent, up from 13.2 percent in 2001, well above the target range of 12.5 - 14.5 percent (Chart 3). However, once an adjustment is made to take account of the extension and subsequent early repayment of loans, using offshore funds, by some large borrowers, underlying credit growth in 2002 was 21.3 percent, compared to 18.6 percent in 2001.*

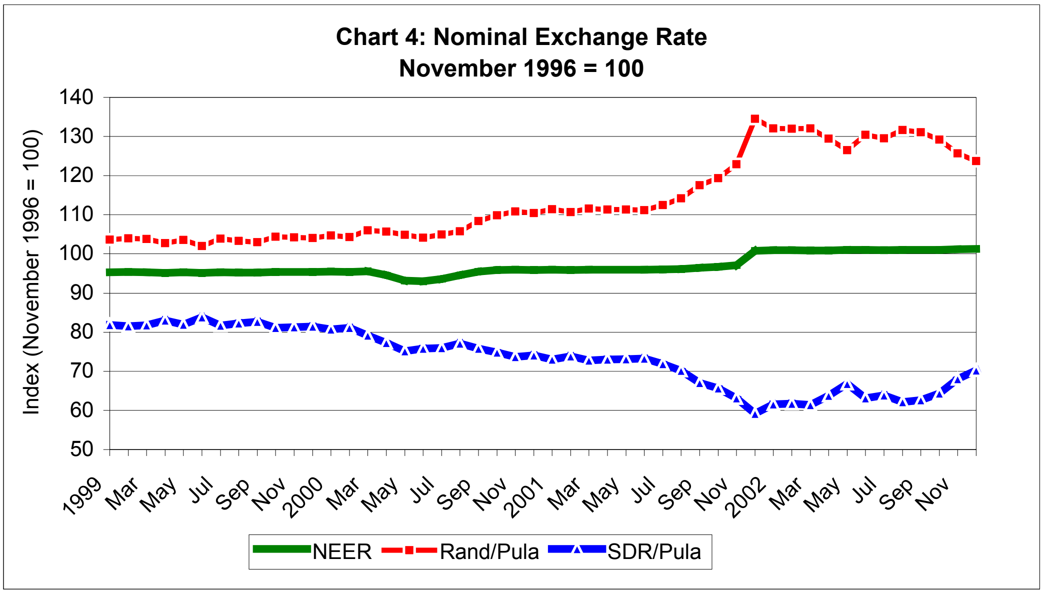
4.3 *Government expenditure is estimated to have grown by 18 percent during 2002, slightly below the 20 percent growth recorded in 2001 (Chart 3). The high rate of growth of government spending continued to be of concern from a monetary policy perspective, since it was not consistent with the inflation objective being pursued and was resulting in an undesirable imbalance between fiscal and monetary policies.*



4.4 *Economic growth for 2001/02 was 2.3 percent, markedly lower than the 8.4 percent recorded during the 2000/01 national accounts year[3]. The significant slowdown in growth largely reflected developments in the mining sector, where output contracted by 3.1 percent, compared to growth of 17.2 percent in the previous year. However, in many other sectors there was robust growth, and the growth rate of non-mining GDP was a healthy 5.5 percent, up from 4 percent in the previous year. This outturn is close to the trend growth rate of 6 percent for non-mining GDP envisaged over the eighth National Development Plan (NDP 8) period of 1997-2003.*

4.5 *During 2002, the Pula appreciated in nominal terms against major international currencies, following the recovery of the rand from losses sustained towards the end of 2001 (Chart 4). The 29 percent appreciation of the rand against the SDR[4] is largely attributable to a prudent macroeconomic policy in South Africa, a more favourable assessment of South Africa vis-a-vis other emerging markets by international investors, a perception that the rand had become undervalued and the weakness of the US dollar. As a result of the link to the rand through the currency basket[5], the Pula strengthened by 27.9 percent against the US dollar and 18.6 percent against the SDR during 2002, while depreciating by 8 percent against the rand.*

4.6 *The trade-weighted nominal effective exchange rate of the Pula was largely stable in 2002; it appreciated by 0.5 percent, as the impact of appreciation against the SDR was offset by depreciation against the rand. As inflation was higher in*

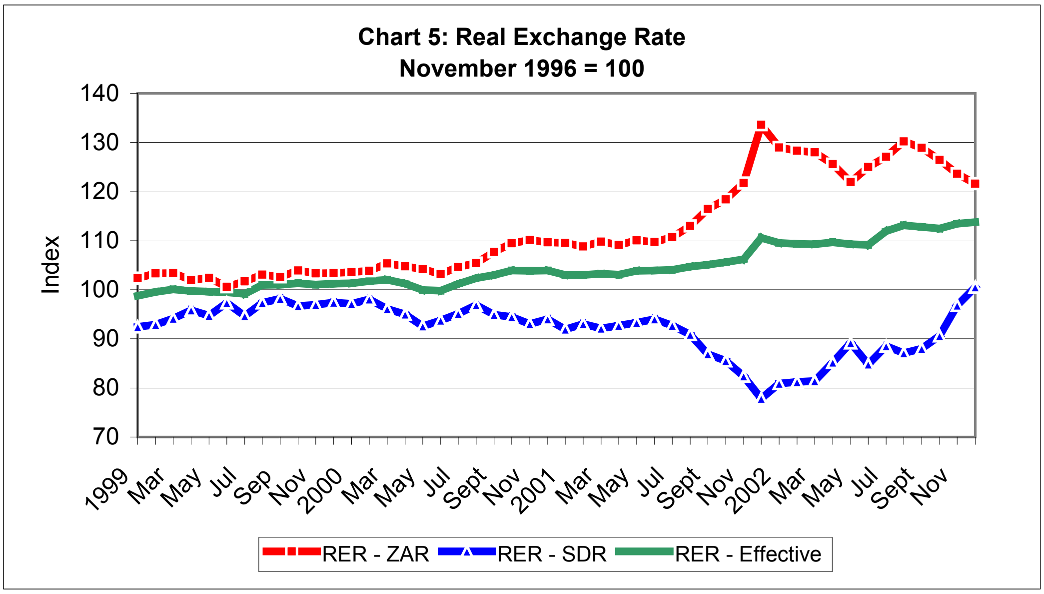


3 The national accounts year runs from July to June

4 The IMF's Special Drawing Right, which is a weighted composite of the US dollar, Japanese yen, euro and pound sterling.

5 The nominal value of the Pula is fixed to a trade-weighted basket of currencies comprising the South African rand and SDR

Botswana than in trading partner countries, mainly due to the impact of VAT, the real effective exchange rate of the Pula appreciated by 2.9 percent in the year to December 2002 (Chart 5), thus eroding competitiveness.



5. *MONETARY POLICY IMPLEMENTATION DURING 2002*

5.1 *The objective of monetary policy in 2002 was to sustain the downward trend in inflation and to keep it within the desired range of 4 - 6 percent. This was to be achieved by adopting a monetary policy stance designed to restrain the growth of domestic demand, especially demand arising from growth in domestic credit. This policy stance was re-emphasised in the mid-year review of the 2002 Monetary Policy Statement.*

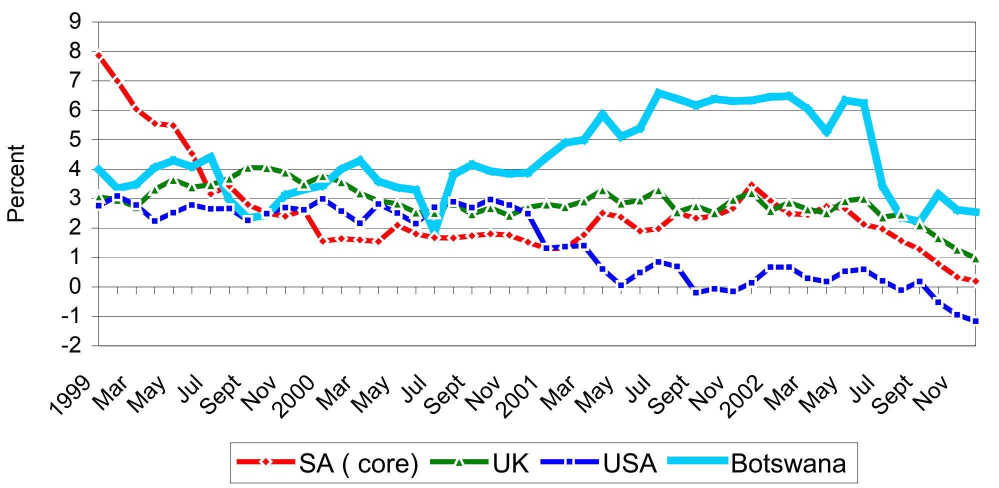
5.2 *As noted earlier, domestic demand continued to be expansionary. The growth rate of commercial bank credit remained at levels above the desired range throughout 2002, and the growth of government expenditure was similarly inconsistent with the inflation objective. Although underlying inflation is estimated to have been between 6 percent and 7 percent by the end of 2002, close to the desired range for inflation, it was, nevertheless, clear in the second half of 2002 that public expectations of a more sustained increase in inflation were starting to build up.*

5.3 *Looking ahead, the Bank considered that the continued high rates of growth of credit and government spending would add to inflationary pressures, leading in due course to an increase in underlying inflation significantly above the desired range. Therefore, in order to reduce demand pressures, especially those emanating from credit expansion, and to influence expectations of low inflation, the Bank Rate was increased by a total of 100 basis points in October and November (50 basis points each time) to 15.25 percent.*

5.4 *Open market operations were conducted during the year to ensure that yields on Bank of Botswana Certificates (BoBCs) were consistent with the policy stance. Between January and September 2002, the three-month BoBC rate*[6] *ranged between 12.52 percent and 12.55 percent, increasing to 14.03 percent by the end of the year, following the increase in the Bank Rate. Open market operations were used to sterilise a substantial increase in market liquidity during 2002, largely due to the P4.9 billion funding of the Public Officers Pension Fund by Government and the general increase in government expenditure. These two factors were reflected in a 30 percent decrease in government deposits at the Bank of Botswana and an increase of 49 percent in BoBCs outstanding to P7 664 million at end-2002.*

5.5 *As a result of the increase in the Bank Rate, which signals the desired direction and levels of interest rates, commercial banks raised their lending and deposit rates. The average 88-day deposit rate rose from 9.81 percent to 10.15 percent, while the prime-lending rate rose from 15.75 percent to 16.75 percent. Real interest rates in Botswana were generally relatively high and stable during the first half of the year, but declined sharply in the second half of the year as inflation rose. As at the end of the year, the real three-month BoBC rate declined to 2.5 percent, from 6.5 percent in January and 6.2 percent in June. Despite the decrease, real interest rates in Botswana were higher than those of major economies and South Africa (Chart 6).*

Chart 6: International Real Interest Rates



6. *OUTLOOK FOR INFLATION IN 2003*

6.1 *Global economic performance is expected to improve further in 2003, with world output forecast to grow by 2.5 percent, up from an estimated 1.7 percent for 2002. Global inflation is expected, nevertheless, to remain stable and low as world output*

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[6] Figures refer to the BoBC mid-rate, as published in the Botswana Financial Statistics.

growth remains below trend. There is, however, uncertainty surrounding oil prices due to a possible war in Iraq. As inflation continues to be largely under control, it is anticipated that the major economies will maintain stimulative monetary policy which, in some instances, will be supported by expansionary fiscal policy.

6.2 Inflation in South Africa, which is the most important external influence on inflation in Botswana, rose sharply during 2002; but it is expected to slow down in 2003, reflecting the recent strengthening of the rand, the tight monetary policy stance and supportive fiscal policy. It is, however, unlikely that South Africa's inflation target of 3 – 6 percent will be met during 2003. Nevertheless, it is not expected that monetary policy will be tightened further unless new inflationary threats emerge, due to concerns about economic growth. Core inflation in South Africa is forecast to fall to between 7 percent and 8 percent in 2003, from 12.2 percent in 2002. For the SDR countries, inflation is forecast at 2 percent in 2003, the same as at the end of 2002. If the nominal effective exchange rate of the Pula is unchanged, Botswana's imported inflation is likely to be lower in 2003 than it was in 2002, although there may be a lagged impact of the 2002 inflation increase in South Africa and globally.

6.3 Although domestic demand, as indicated by the growth in commercial bank credit and government expenditure, remains undesirably high, it is expected that the increase in interest rates in the last quarter of 2002 will, in due course, moderate the demand for credit. Furthermore, the 2003 budget indicates that government expenditure will grow at a much slower rate of 4.1 percent in 2003, which will, together with an expected reduction in credit growth, help to moderate inflationary pressures. The Government's decision not to award a public sector pay rise in 2003 will further help to restrain demand pressures, and it is hoped that this will not be undermined by the findings of the ongoing Salary Structure Review Commission. Prospects in 2003 are of a better balance between monetary and fiscal policies in restraining overall expenditure growth.

6.4 Overall, it is expected that inflation in the first half of 2003 will be around present levels of between 10 percent and 12 percent, before falling significantly in the middle of the year to between 6 percent and 7 percent. This projection reflects the dropping out of the inflation calculation of the VAT-related increase in prices in mid-2002. It also assumes that monetary policy is successful in restraining credit growth, that the growth of government spending is reduced in 2003, and that there are no further undue external inflationary pressures generated by further large increases in food or oil prices.

7. MONETARY POLICY STANCE IN 2003

7.1 As indicated in Section 2 above, the Bank seeks 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. The inflation objective, therefore, reflects an assessment of forecast inflation for trading partner countries. Given that forecast trading partner inflation for 2003 is higher than similar forecasts for 2002, on which the inflation objective was based, this could imply a slightly higher range for the inflation objective in the current year than in 2002.

7.2 There are, nevertheless, strong reasons to maintain the inflation objective in 2003 at the range of 4 - 6 percent. First, by helping to bring Botswana's inflation rate below that of trading partners, it provides an opportunity to regain some of the competitiveness lost last year as a result of the higher rate of inflation in Botswana. Second, excluding the impact of VAT, underlying inflation remains close to the upper end of this objective. In this respect, the 4 – 6 percent range remains a feasible objective. Third, looking ahead and in light of concerns about the risks of a further VAT-included increase in inflationary expectations, the Bank believes that it is important to maintain expectations of sustainable low inflation.

7.3 The range for the growth rate of private credit that is considered to be compatible with achieving this inflation outcome is 12 – 14 percent. As in the past, this range is derived from the expected annual capacity for growth (aggregate supply) of the non-mining sector of the economy, as presented in the ninth National Development Plan (NDP 9), and desired inflation for the year, with an allowance for the process of financial deepening as the economy develops.

8. SUMMARY AND CONCLUSIONS

8.1 Inflation was higher in 2002 compared to 2001, and was above the inflation objective indicated in the 2002 Monetary Policy Statement. The higher inflation was largely explained by the temporary impact of VAT on prices in the second half of the year, while underlying inflation was at the upper end of the 2002 target range. Inflation was also affected by drought conditions in Southern Africa, which had an impact on food prices. Nevertheless, overall domestic expenditure growth was high, raising concerns about future inflation trends.

8.2 During 2003, it is expected that output growth will improve in major industrial countries, while inflation will remain under control. Except for a possible increase in oil prices due to conflict in the Middle East, a possible war in Iraq and the lagged impact of the previous year's increase in South African inflation, there is minimal risk of external pressures on inflation. Domestically, it is anticipated that credit demand will slow in response to the increase in interest rates in 2002, helping to alleviate demand pressures. Fiscal restraint, as shown in the much reduced growth rate for Government spending announced in the 2003 Budget, should also contribute to reducing inflationary pressures in 2003.

8.3 The task for monetary policy in 2003 will be to ensure that underlying inflation does not increase and the expected decline in overall inflation is consistent with the Bank's desired range of 4 - 6 percent by the end of the year. The Bank took a step late last year to increase the cost of credit and, therefore, moderate its growth, as well as curtail higher inflationary expectations. While the Bank will continue to respond appropriately to monetary and inflation developments, the fiscal restraint that characterises the 2003 Government Budget should help to ensure that the burden of containing inflation will be shared in a more balanced manner between monetary and fiscal policies during 2003.