MONETARY POLICY STATEMENT 2006

by

Linah K Mohohlo
Governor, Bank of Botswana

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17938 Khama Crescent Gaborone Tel: (267) 360-6000 Facscimile:(267) 390-9016
website: www.bankofbotswana.bw

BANK OF BOTSWANA

MONETARY POLICY STATEMENT - 2006

1. INTRODUCTION

1.1 As in the past, this year's Monetary Policy Statement (MPS) serves three purposes. First, it reviews developments in inflation and the underlying causes in the previous year and explains how the Bank responded in the context of the monetary policy framework. The Statement also assesses the extent to which monetary policy was successful in achieving the inflation objective for 2005. Second, the MPS evaluates prospective economic and financial developments in 2006 and their potential impact on domestic inflation. Third, given the assessment of economic and financial prospects, the Bank decides on the inflation objective for the ensuing period and explains how monetary policy will be formulated and implemented to achieve the inflation objective. This means that the MPS plays an important role in conveying to stakeholders and the public at large information relating to the formulation and implementation of monetary policy in the context of the Bank's objective of price stability. It also seeks to foster public expectations of sustainable low inflation.

1.2 For the first time since the Monetary Policy Statement was initiated, the Bank has decided to specify an inflation objective for the medium term (3-year horizon) in addition to the annual objective.

1.3 Inflation fell in the first four months of 2005 but rose thereafter due to the impact of the 12 percent devaluation of the Pula on import prices as well as the rise in administered prices; these factors accounted for about half the level of inflation by year-end. This means that while the Bank's inflation objective range was raised at mid-year from 3 – 6 percent to 4 – 7 percent to take account of the anticipated impact of the devaluation, inflation ended the year above the upper end of the revised objective. Meanwhile, domestic demand pressures were subdued partly due to moderate government expenditure, erosion of purchasing power attributable to higher prices following the devaluation and the absence of a civil service salary increase during 2005. Restrained demand was reflected in a decrease in the annual rate of growth in commercial bank credit during the year which, together with the slower growth in government expenditure, was supportive of the inflation objective. Globally, oil prices remained at high levels, easing towards the end of the year, albeit having only a modest impact on inflation given productivity improvements, increased competition in the goods market and pre-emptive monetary policy tightening in some of the major economies.

1.4 External inflationary pressures are expected to remain moderate, while domestic demand is expected to increase modestly, albeit with an anticipated small influence on inflation. There is, nevertheless, uncertainty with respect to further possible increases in administered and commodity prices. Overall, domestic inflation is expected to stabilise at around the current level of 16 percent in the first half of 2006 and to decline thereafter.

2. MONETARY POLICY FRAMEWORK AND OBJECTIVES

2.1 Monetary policy in Botswana aims at achieving a sustainable, low and predictable level of inflation that, among others, contributes towards the broader national objectives of sustainable economic growth and development. In recognition of the transmission process of policy changes which takes time to affect the ultimate objective, and in order to sustain a measured response to inflation developments that is not costly in the short-term so far as employment and output growth are concerned, monetary policy should be formulated and implemented within a medium-term horizon of three years. In order to attain its policy objectives, 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, trade and fiscal policies affect the overall level of demand for goods and services in the economy, relative to the country's potential level of output. Inflationary pressures are likely to emerge when the demand for goods and services exceeds the capacity of the domestic economy to supply goods and services.

2.2 When formulating monetary policy for the period ahead, the Bank closely examines the potential sources of inflation and seeks to respond primarily to changes in inflation that are due to domestic demand pressures. It is against this background that the Bank examines measures of underlying or core inflation, which are more closely associated with expectations and demand components of headline inflation[1] in addition to examining the headline inflation data published by the Central Statistics Office. However, the Bank stands ready to respond to any impact that these excluded items might have on underlying inflation through inflation expectations and second-round effects.

2.3 The Bank focuses on 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 can be directly influenced by monetary policy

[1] The Bank's preferred measure of core inflation is based on the trimmed-mean approach. This approach removes the most extreme price changes, regardless of their source. The core inflation rate is currently calculated by the Bank from data published by the Central Statistics Office.

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 fiscal and monetary policies to complement each other for macroeconomic stability. In addition to these demand factors, the Bank also responds to other sources of inflation to the extent that they may generate second-round effects and influence inflation expectations.

3. INFLATION IN 2005

3.1 Inflation eased at the beginning of 2005 as the impact of the 7.5 percent devaluation of the Pula of February 2004 fell out of the inflation calculation. By April 2005, it had dropped from 7.8 percent in December 2004 to 6.2 percent, and only marginally higher than the upper end of the Bank's 3 – 6 percent inflation objective set at the beginning of the year. Following another devaluation (12 percent) at the end of May 2005, the annual rate of increase in consumer prices accelerated significantly, reaching 11.4 percent in December 2005 (Chart 1). There were also significant increases in some administered prices during the period. It is estimated that the 2005 devaluation contributed between 3 and 4 percentage points to inflation during the year, mainly as a result of higher Pula-denominated import prices[2]; imported tradeables inflation rose from 7.6 percent to 15.8 percent in 2005; moreover, there were several increases in fuel prices during the year, necessitated by the substantial increase in international oil prices, and these cumulatively contributed around two percentage points to inflation.

3.2 Overall, the annual increase in the cost of all-tradeables rose from 6.9 percent in 2004 to 13.6 percent in 2005, compared to a deceleration in inflation for non-tradeables, from 10.2 percent to 6 percent over the same period. It is noteworthy that without the specific rise in telecommunications and electricity tariffs, which contributed about one percentage point to inflation, the annual rate of increase in prices for non-tradeables would have been slower. This suggests that there have been so far only limited second-round effects from the May 2005 devaluation and administered price increases, and that underlying inflation has been contained in the context of a relatively restrictive monetary policy[3].

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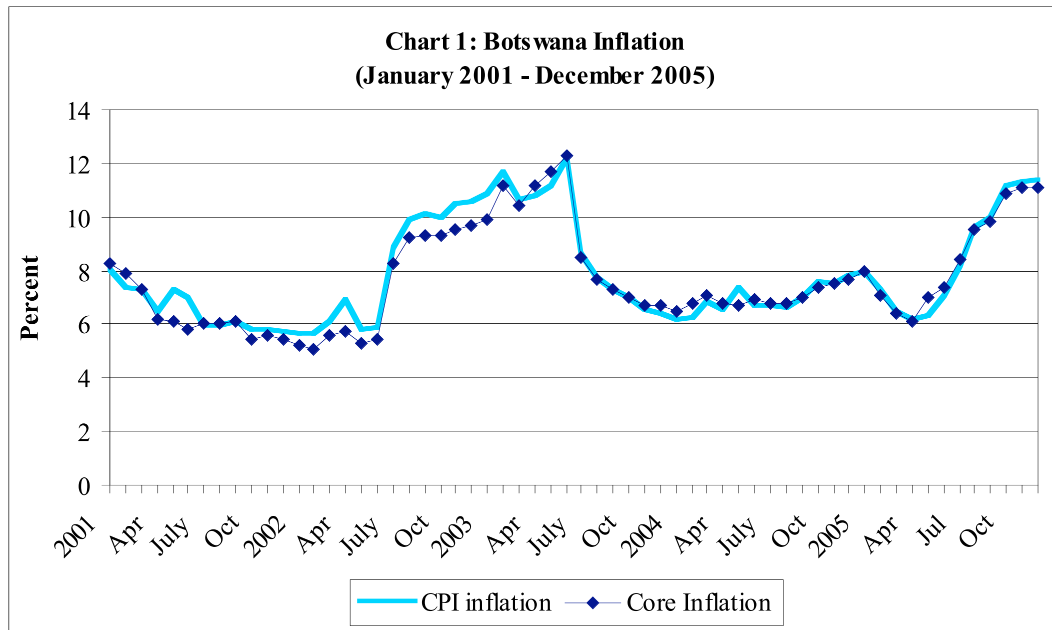
[2] This is based on the assumption that in the context of only marginal changes in the rand/Pula exchange rate, the rate of changes in import prices would have been similar to South African inflation.

[3] About 16 percent of items in the consumer price index basket have prices that are administratively set by the Government and various parastatals outside the process of normal free market price determination. It is recognised, however, that these price adjustments are influenced to some degree by general price developments. However, these price changes are not directly influenced by monetary policy, hence monetary policy will not normally respond to them, except to the extent that they are expected to influence"free" market prices, especially through second round effects.

3.3 *Without the impact of the devaluation and increases in administered prices, inflation is estimated at just above 5 percent for 2005, which is within the 4 – 7 percent objective[4]. Nevertheless, the core inflation measure - the 16 percent trimmed mean - also rose significantly during the year, from 7.7 percent in December 2004 to 11.1 percent in December 2005, thus signifying a generalised impact of the devaluation on the rate of price increases for items in the consumer price index basket.*



4. *INFLUENCES ON DOMESTIC INFLATION IN 2005*

4.1 *The world economy remained buoyant in 2005 although output growth fell from just above 5 percent the previous year to 4.3 percent, largely due to slower gross domestic product (GDP) growth in the United States of America (USA) and China[5]. Inflation was largely unchanged in the major industrial countries, having fallen slightly to 2.5 percent. While inflation was mainly influenced by the rise in international oil prices, there was offsetting downward pressure in these countries resulting from continuing productivity growth, competition in the goods market and pre-emptive monetary policy tightening in several major economies. In South Africa, inflation fell from 4.3 percent in December 2004 to 4 percent in December 2005, thus remaining within the target range of 3 - 6 percent. Given*

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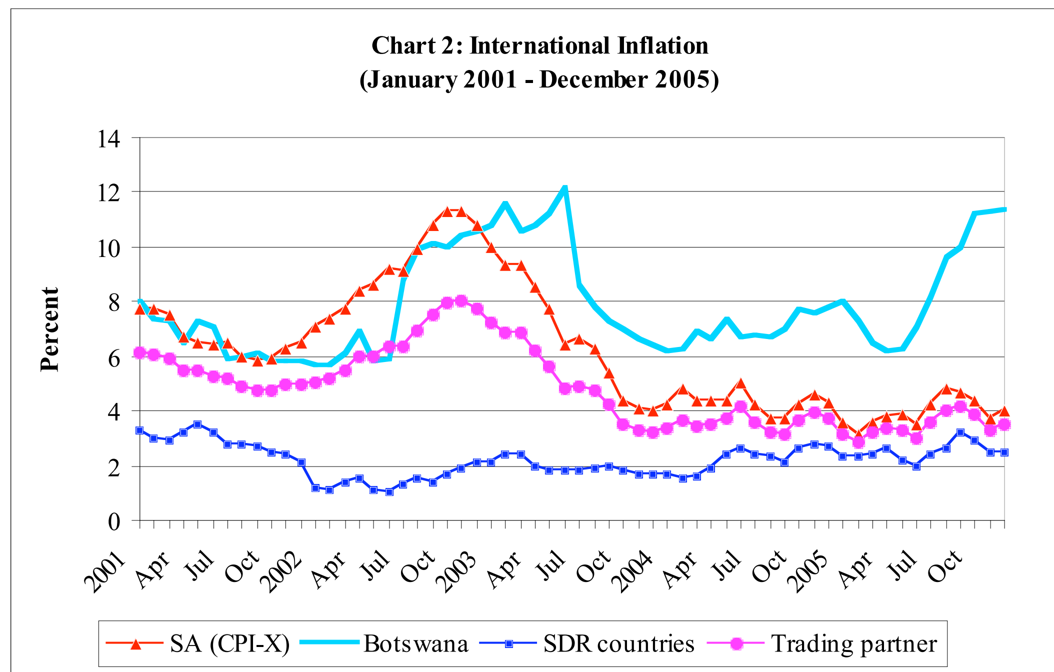
[4] *This represents the Bank's unofficial measure of underlying inflation; it serves only to explain and illustrate inflation developments.*

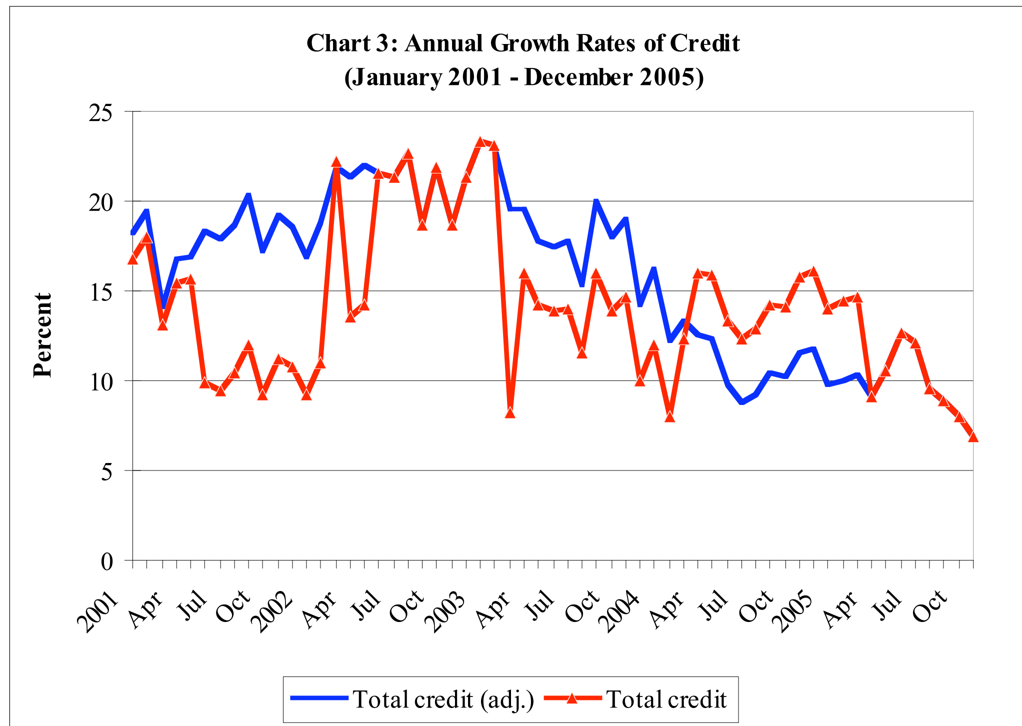
[5] *Estimates for global developments are drawn from the International Monetary Fund's World Economic Outlook.*

the generally positive outlook, the South African Reserve Bank reduced interest rates by 50 basis points in April 2005 and no changes were made for the remainder of the year. The combined effect of these developments was that average inflation for Botswana's trading partner countries declined to 3.5 percent in 2005. A comparison of inflation trends for Botswana and trading partner countries is shown in Chart 2 below.



4.2 *Domestically, overall demand conditions were generally non-inflationary, although total output growth was buoyant at 8.3 percent in 2004/05 compared to 3.4 percent in 2003/04, mostly due to a higher increase in diamond output of 18.2 percent (0.2 percent in 2003/04). When mining is excluded, GDP growth was much slower at 1.9 percent from 5.6 percent the previous year. Growth was even slower at 1.2 percent (5.8 percent in 2003/04) when government is excluded, indicating a significantly reduced performance of the non-mining private sector.*

4.3 *The slower private sector output growth was also noticeable from the decrease in the annual rate of growth in commercial bank credit to the private sector, which declined from 11.8 percent in December 2004 to 7.3 percent in December 2005, compared to the Bank's desired range of 11 – 14 percent. The reduction in the rate of borrowing was partly the result of a relatively restrictive monetary policy and the restrained rate of growth in government expenditure. Moreover, the absence of an increase in public service salaries during 2005 is considered to have contributed to a substantially reduced rate of annual increase in credit to households, which dropped from 26.6 percent in December 2004 to 9.2 percent in December 2005. Growth of business credit, on the other hand, rose slightly to 4.8 percent year-on-year, compared to 4.3 percent of the previous year (Chart 3).*



4.4 *Total recurrent and development expenditure growth was low during 2005, thus adding to the downward pressure on demand. The revised estimates announced in the 2006 Budget Speech indicate that spending in fiscal year 2005/06 will be 14.5 percent higher than spending in 2004/05; this compares with a much lower annual growth of 2.8 percent between 2003/04 and 2004/05 (Chart 4)* [6]. *The faster expenditure growth in 2005/06 is attributed to the 14.8 percent increase in recurrent expenditure, compared to the 2004/05 expenditure growth of 6.4 percent, while development expenditure is projected to grow by 13.8 percent in 2005/06 compared to a contraction of 8.1 percent registered in 2004/05.*

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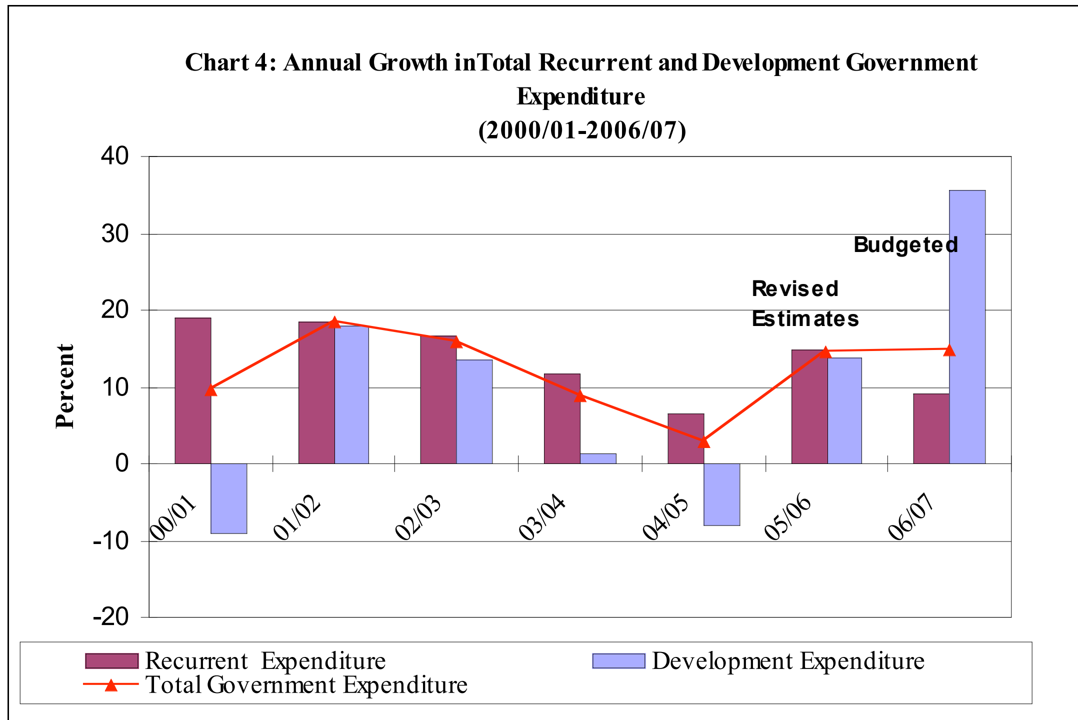
[6] *The higher revised estimate for the whole of 2005/06 suggests accelerated spending in the latter part of the fiscal year, given that growth in spending was much lower during most of 2005.*



4.5 *Another major influence on inflation during 2005 was the 12 percent devaluation of the Pula at the end of May 2005 that was accompanied by the introduction of a crawling band exchange rate regime. However, the Pula continued to be pegged to a basket of currencies comprising the South African rand and the IMF Special Drawing Right (SDR)*[7]*. In the crawling band arrangement, the Pula is adjusted in small continuous steps, rather than in large discrete ones, based on the differential between the Bank's inflation objective and the forecast inflation for trading partner countries on a forward looking basis. Furthermore, to introduce more flexibility in the exchange rate, the symmetrical band around the central parity was widened from +/-0.125 percent to +/-0.5 percent. This is designed to encourage the development of the domestic foreign exchange market and a more market determined exchange rate which is responsive to changes in economic fundamentals.*

4.6 *The crawling band exchange rate regime creates an environment conducive to a more proactive monetary policy which, over time, should reinforce its effectiveness. While monetary policy focuses on attaining a low and stable inflation to achieve real exchange rate stability in the longer term, domestic inflation may deviate significantly from trading partner countries' inflation in the short term, resulting in a depreciation or appreciation of the real effective exchange rate and necessitating an adjustment to correct for the misalignment. In the context of the new exchange rate regime, this is achieved by continuous small adjustments. Another advantage of the new framework is enhanced transparency*

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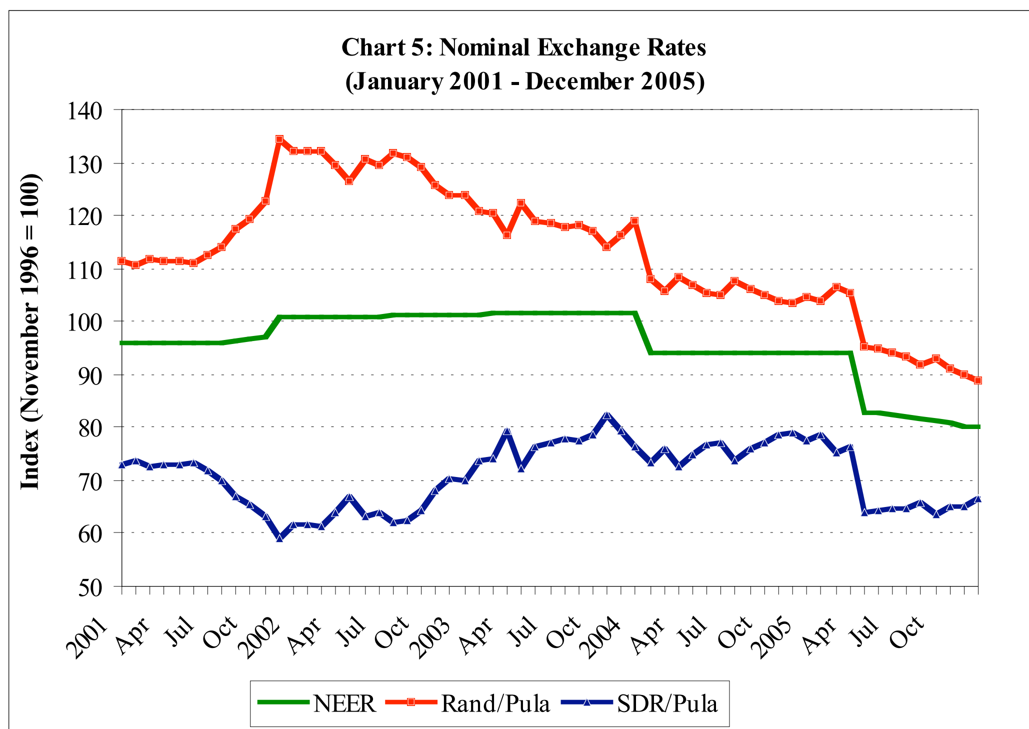
[7] *The SDR is a composite currency used by the IMF comprising the US dollar, British pound, Japanese yen and euro. The SDR and the South African rand constitute the Pula basket.*

in the determination of the exchange rate, which helps market participants and the public to make informed decisions. To the extent that monetary policy is successful in achieving its inflation objective, however, adjustments of the nominal effective exchange rate (NEER) become unnecessary to obtain real effective exchange rate (REER) stability.

4.7 The 12 percent devaluation of May 2005 and the new exchange rate mechanism have meant that the nominal exchange rate, which had been stable after the 7.5 percent devaluation of February 2004, had depreciated by 14.5 percent by December 2005 (Chart 5). The overall effect is that the Pula appreciated by 2.5 percent against the SDR in the seven months to December 2005, but depreciated by 5.4 percent against the rand, thus worsening the devaluation effect of the rand/Pula exchange rate on domestic inflation.



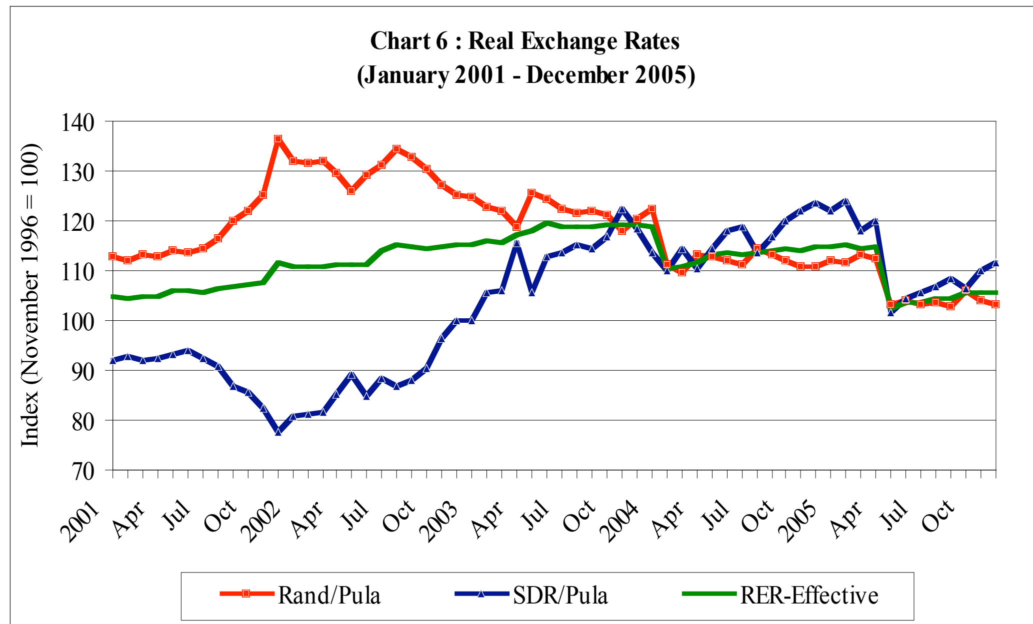
5. MONETARY POLICY IMPLEMENTATION DURING 2005

5.1 The inflation objective for 2005 was revised downwards from 4 – 7 percent in 2004 to 3 - 6 percent at the beginning of the year, taking account of the positive inflation outlook at the time and with a view to sustaining expectations of low inflation. Indeed, monetary policy was eased in April 2005 and the Bank Rate reduced by 25 basis points to 14 percent. The inflation outlook changed, however, as a result of the devaluation of the Pula at the end of May 2005, with inflation expected to rise significantly due to the effect of the lower rand/Pula exchange rate on import prices. The Bank's estimate at the time was that the

exchange rate adjustment would increase inflation over a period of 10/12 months by 3 – 4 percentage points. In the circumstances, the Bank's inflation objective range was increased to 4 – 7 percent. The increase was smaller than the expected impact of the devaluation, thus signalling a desire by the Bank to contain the extent of price increases arising from the exchange rate adjustment and the continuation of a fall in the annual price increase for non-tradeables. In particular, the Bank sought to prevent the rise in inflation from feeding through to prices of domestic resources and domestically produced goods and services. This approach recognised that, in order for Botswana's resources to remain competitive, the prices of those resources must not rise as much as the devaluation. Consistent with the revised inflation objective, the desired rate of credit growth, which had been set at a range of 10 – 13 percent at the beginning of the year, was also increased to a range of 11 – 14 percent.

5.2 While the Bank's inflation objective was increased with a view to anchoring inflation expectations, monetary policy was adjusted in the second half of the year in response to price developments that were likely to impact on the medium-term inflation path. The Bank Rate was increased on two occasions (in August and October, 2005) by 25 basis points on each occasion to 14.5 percent. The continuing high levels of international oil prices necessitated an increase in domestic fuel prices, and there was also a significant increase in some other administered prices, thus contributing to a further acceleration in inflation. Overall, monetary policy remained restrictive during 2005 as inflation was above the Bank's inflation objective, with the policy stance having an apparent effect on demand and expectations and, therefore, contributing to restrained secondary effects of both the devaluation and the increase in administered prices.

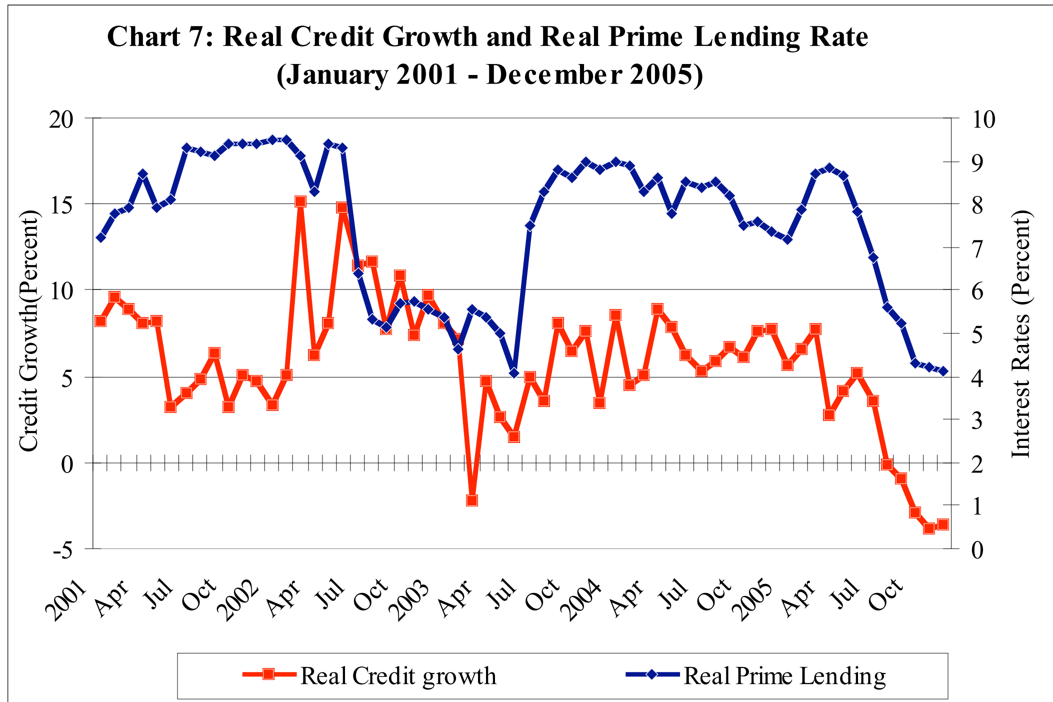
5.3 At the lower end, the revised inflation objective was close to trading partner countries' inflation and the upper end of the objective (and expectations with respect to the inflation outcome) was used as a basis for the determination of the rate of crawl. If the trading partner countries' average level of inflation had been achieved, it would have contributed to a stable REER. However, as inflation in Botswana remained much higher than both the inflation objective and trading partner countries' inflation, the REER appreciated by 3.7 percent in the seven months to December 2005, following the devaluation in May 2005 (Chart 6). This indicated that the rate of crawl did not fully offset the inflation differential between Botswana and the trading partner countries. However, it should be recognised that the achievement of a stable REER must be assessed over the medium- to long-term, particularly in circumstances where the rise in inflation is due to correctional devaluation, which is expected to have a transitory impact on inflation. There is a possibility that an increase in administered prices may be muted in future as gains in productivity are achieved and as the Government fully implements cost recovery measures on social services. This underscores the need for productivity improvements as it is key in achieving global competitiveness and would reduce the burden on monetary policy and the exchange rate, both of which can impact negatively on economic activity in the short run.

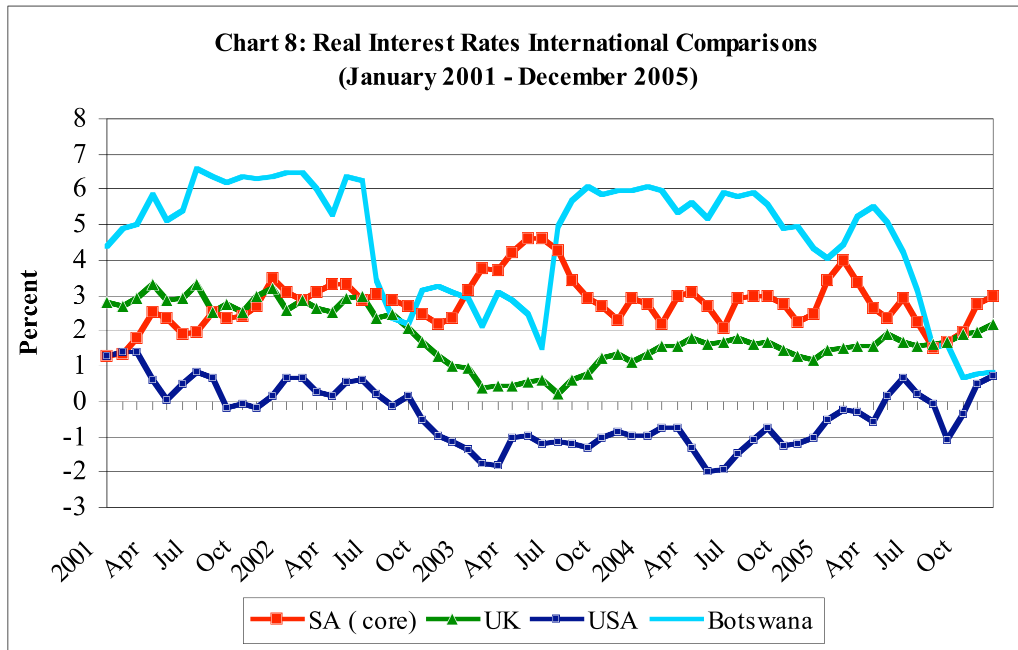


5.4 *The Bank's open market operations supported monetary policy by ensuring that short-term interest rates, particularly yields on Bank of Botswana Certificates (BoBCs), were consistent with the Bank's monetary policy stance. Hence, yields on the 14-day paper were higher by the end of the year than in 2004, rising from 12.01 percent in December 2004 to 12.27 percent in December 2005. However, for the 3-month paper, the yield decreased from 12.5 percent to 12.32 percent over the same period. The slower increase in BoBC yields and the fall in yield for the 3-month paper, reflected a higher demand for BoBCs, largely due to additional government transfers to the Public Officers Pension Fund (POPF) and the maturity of the 2-year government bond in June 2005.*

5.5 *The yield curve was inverted during the year, with shorter-term interest rates higher than longer-term interest rates. This reflected local investors' demand for longer-dated instruments, as well as expectations of a decline in inflation and lower short-term interest rates in the medium to long-term. Furthermore, commercial bank deposit and lending interest rates were increased in response to monetary policy tightening; the average prime lending rate rose from 15.75 percent at the end of 2004 to 16 percent at the end of 2005, but the average 88-day deposit rate fell from 9.13 percent to 8.88 percent over the twelve months period. In the environment where inflation increased faster than nominal interest rates, real interest rates fell markedly, with the real 3-month BoBC rate falling from 4.4 percent in 2004 to 0.8 percent in 2005 and, similarly, the real prime lending interest rate declining from 7.4 percent to 4.1 percent. The comparable 3-month money market interest rates for South Africa, UK, USA and the Euro 12 were 3 percent, 2.2 percent, 0.7 percent and 0.2 percent, respectively, at the end of 2005. Charts 7 and 8 below show trends in real credit growth and the prime*

lending rate in Botswana, as well as movements in selected country real interest rates, respectively.





6. OUTLOOK FOR INFLATION IN 2006

6.1 The outlook for the world economy in terms of growth and inflation is positive, although there is uncertainty with respect to energy costs and the impact on economic activity of sustained oil price increases. World output is estimated to have expanded by 4.3 percent in 2005 and a similar rate of growth is forecast for 2006. This is equal to the long-term average rate of global output expansion, but is lower than the 5.1 percent output growth of 2004, as economic activity was dampened by the higher price of oil. Inflationary pressures continue to be restrained internationally despite the high oil price, which reached a high of about 70 US dollars (USD) per barrel in January 2006 due to concerns over supply disruptions in some of the major producer countries. Global inflation is forecast to decline modestly in 2006 from around 4 percent in 2005 as productivity growth, competition in the finished goods markets and further monetary policy tightening in some countries continue to counteract the effects of commodity price increases. Average inflation in the SDR countries is also forecast to rise marginally to around 3 percent in 2006.

6.2 Inflation in South Africa, which is the most important external influence on domestic price changes, is forecast to rise from 3.5 percent in 2005 to 4.7 percent in 2006, and to remain within that country's target range of 3 - 6 percent. The South African rand is forecast to depreciate modestly in 2006, thus having a relatively small impact on domestic price changes. Although there continues to be uncertainty with respect to the price of oil, upside risks appear limited in the short-term and, overall, the external influences on domestic prices are expected to remain benign.

6.3 Domestically, government expenditure is budgeted to grow annually by about 15 percent (Chart 4) and, if achieved, should add significantly to demand pressures. Additional increase in demand will also be engendered by the 8 percent increase in civil service salaries and the net gain from personal tax adjustments[8] given their likely effect on credit expansion. It is for this reason that monetary policy must remain restrictive in order to reduce inflation so that it can move towards that of the average of trading partner countries.

6.4 It is envisaged that the downward crawl of the exchange rate, which reflects the difference between the Bank's 2006 inflation objective average and the forecast trading partner countries' average inflation, will not result in a substantial nominal exchange rate adjustment. It should, therefore, not add significantly to inflationary pressures, particularly in the context of a relatively restrictive

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[8] A net gain on disposable income will be achieved due to the increase in the untaxable threshold from P25 000 to P30 000 and the increase from P100 000 to P120 000 of the amount from which the maximum rate will be applicable.

monetary policy[9]*. However, any upward changes in administered prices will have a significant influence on inflation in 2006. For instance, as recently announced by the Central Statistics Office, the impact of the re-introduction of school fees added about 5 percentage points to inflation. It is also likely that those parastatals that did not increase their prices in 2005 will do so in 2006, thus fuelling inflationary pressures. On the positive side, while there is uncertainty with respect to developments in international oil prices, there is a possibility that a forecast decrease will engender a reduction in domestic fuel prices and ease pressure on inflation.*

6.5 Overall, given the expected modest increase in demand pressures and the benign influence of foreign price developments, inflation is expected to stabilise at levels around 16 percent in the first and second quarters of 2006, mainly due to the impact of the re-introduction of school fees. The annual increase in prices is expected to decline thereafter as the impact of the devaluation and the 2005 administered price increases drop out of the inflation calculation, depending on developments in prices of non-tradeables. It follows, therefore, that inflation that reflects underlying demand pressures in the economy is much closer to inflation in trading partner countries which, as described below, is the Bank's medium to long-term price stability objective.

7. MONETARY POLICY STANCE IN 2006

7.1 As indicated above, monetary policy is conducted to achieve price stability and to contribute towards attaining relative REER stability through achieving a rate of inflation that, at a minimum, is close to the average of that of trading partner countries. However, under the crawling band framework, to the extent that the inflation objective remains different from the average of inflation in trading partner countries, a rate of crawl equivalent to the differential should contribute towards stability of the REER. For 2006, trading partner countries' inflation is forecast to be unchanged from that of 2005, and this implies that the Bank should lower its objective from the 4 - 7 percent adopted in the second half of 2005. This way, the Bank should be able to achieve the intended REER stability in the short-term, without adjusting the nominal exchange rate. However, inflation is expected to remain significantly above 7 percent in 2006, which would be much higher than the average inflation rate in trading partner countries, even after the impact of the devaluation falls out of the inflation calculation. This is mainly due to the continuing influence of an increase in administered prices. Given the sources of inflation, it would be unrealistic and costly in terms of output and employment for the Bank to try and counter the full inflationary effect of these factors over too short a period of time. Consequently, it remains necessary to

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[9] *It should be noted that even in the context of a downward crawl of the NEER, changes in bilateral exchange rates against the Pula will not always be downward, given the basket mechanism and movements in cross exchange rates.*

accept some of the direct increase in inflation due to these factors, while maintaining a relatively tight monetary policy stance to contain any secondary inflationary effects and to shape inflation expectations. Meanwhile, a downward crawl of the NEER will help in stabilising the REER and achieve the degree of competitiveness needed in pursuit of the national economic diversification objective.

7.2 *Given the short-term volatility of domestic inflation, there are considerable short-term risks related to output and employment costs in attempting to strictly adhere to a short-term (annual) inflation objective. Moreover, to the extent that the Bank is unable to meet the short-term objective mainly because of factors over which it has no control, the credibility of monetary policy and its influence on inflation expectations could be undermined.*

7.3 *Furthermore, fundamental to the execution of monetary policy is an appreciation of the transmission process between a policy change and its impact on the ultimate objective. Invariably, it takes approximately a year for a change in interest rates to influence inflation. Similarly, it takes time to achieve sustained policy success and supportive adjustments in other areas of the economy. A longer term policy horizon should, therefore, provide the Bank with sufficient time to direct its policy actions to the sources of inflation that it can influence in the medium-term.*

7.4 *It is against this background that the Bank has decided to introduce a medium-term (3-year period to 2008) inflation objective of 3 – 6 percent as a means of anchoring inflation expectations over a longer time horizon. This represents an inflation objective that should facilitate robust economic activity and, at the same time, underscores the fact that policy decisions take time to impact on intermediate targets and inflation. The medium-term inflation objective should provide scope for more effective broad policy discussion and coordination with stakeholders towards achieving a low and stable inflation. It should also facilitate productivity improvements as reflected in lower rates of price increases, particularly given the current trend towards achieving more efficient pricing for parastatal and government services.*

7.5 *As an additional policy measure, it is advisable to ensure that the achievement of the medium-term inflation objective is attained over a gradual path, particularly as inflation is expected to remain moderately high in the short-term; hence the Bank will continue to have the annual inflation objective range to guide short-term expectations. For 2006, this objective range is 4 – 7 percent. The aim of monetary policy in 2006 will, therefore, be to bring inflation down within this range, with the objective of an eventual reduction to the medium-term range of 3 – 6 percent.*

7.6 *The rate of growth of commercial bank credit to the private sector is an important contributor to the growth of consumption and investment, and hence aggregate*

demand. Credit growth is the Bank's principal intermediate target as it is considered that the Bank's policy decisions with respect to interest rates affect the rate of credit growth, which influences the consumption and investment components of aggregate demand. Accordingly, the Bank specifies an explicit desired range for credit growth consistent with its inflation objective. This is derived from the projected medium to long-term growth of the non-mining sector of the economy and the desired inflation, with an allowance for the process of financial deepening as the economy develops. The range of credit growth that is considered consistent with the annual inflation objective range of 4 – 7 percent for 2006 is 11 – 14 percent.

7.7 Since the upper end of the Bank's annual inflation objective of 4 – 7 percent is higher than the forecast average inflation of trading partner countries, the fixed Pula exchange rate peg should crawl downward during 2006 and contribute towards achieving a stable REER.

8. SUMMARY AND CONCLUSIONS

8.1 Inflation trended downwards in the first four months of 2005, but rose thereafter as a result of higher import prices following the devaluation of the Pula and an increase in administered prices; it rose to 11.4 percent by year-end and well above the 4 – 7 percent objective range.

8.2 Global economic growth declined slightly in 2005 following strong performance in the previous year, and is expected to stabilise around the current level in 2006. World inflation is forecast to remain under control, particularly given the anticipated relative stability of international oil prices and the effective management of inflation expectations.

8.3 External pressures on domestic inflation are, therefore, expected to remain low in 2006. Furthermore, the restrictive monetary policy stance should ensure sustained moderate demand pressures, even in the context of expansionary fiscal measures announced in the 2006 Budget Speech; credit expansion should generally be consistent with the inflation objective. However, domestic inflation is projected to remain relatively high in 2006 due to the continuing combined effect of the May 2005 devaluation, the increase in administered prices and other charges levied for government services such as school fees.

8.4 Against this background, the challenge for monetary policy in 2006 is to ensure that inflation does not rise beyond the expected increase arising from the devaluation and the increase in administered prices and, therefore, remains within the Bank's annual objective of 4 – 7 percent. It is important to suppress expectations of a significant rise in inflation, thereby contributing towards the realisation of the Bank's objective of low and sustainable inflation. The Bank will, therefore, conduct monetary policy with the objective of ensuring that inflation ultimately falls within the desired medium-term (3-year) objective range

of 3 – 6 percent. To this end, the Bank remains committed to responding appropriately to all economic and financial developments as they relate to keeping inflation in check.