MONETARY POLICY STATEMENT 2008

by

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MONETARY POLICY STATEMENT - 2008

1. INTRODUCTION

1.1 *The Monetary Policy Statement (MPS) reviews trends in inflation and their underlying causes in the past year, and the degree to which the Bank was successful in meeting the inflation objective. It also examines prospective economic and financial factors that are likely to affect the inflation outlook for this year; it explains the policy horizon for which the inflation objective is set, and the policy measures that will be needed to achieve it. In publishing the Statement, the Bank informs stakeholders about the policy framework that guides the formulation of monetary policy. In doing so, the Bank fulfils its obligation of accountability for, and transparency of its monetary policy formulation and implementation as a strategy for anchoring expectations of low, predictable and sustainable inflation.*

1.2 *For this year, however, the Statement highlights some departures from the approaches adopted in the previous years in several respects as a result of the progress the Bank has made in understanding the transmission mechanism of monetary policy. For this reason, this year's Statement focuses on the policy horizon for the inflation objective based on a more rigorous inflation forecasting framework. Therefore, the inflation forecast is now used as a comprehensive and inclusive indicator for policy formulation and implementation, in place of the rate of growth of credit, which served as the indicator of domestic demand pressures. The Bank will still take account of the rate of growth of credit, given that it is one of the contributory factors to demand, by capturing it in the inflation forecast. In view of progress made in forecasting inflation, it is considered unnecessary to continue to use the rate of growth of credit as the only major and distinct intermediate target of monetary policy.*

1.3 *Another departure from previous practice is that the policy horizon will no longer include the annual inflation objective. The reason for this is that the price stability objective can only realistically be achieved in the medium-term; this is in recognition of the time lag for monetary policy to impact on price developments. While an annual inflation objective affords flexibility in a faster adjustment of monetary policy, thus demonstrating the determination to achieve the inflation objective and influence expectations sooner, there could be costs in foregone output and employment growth. The medium-term objective, on the other hand, allows for a measured response and smoother path towards the inflation objective.*

1.4 *So far as developments in 2007 are concerned, inflation followed a downward trend in the first half of the year, declining from 8.5 percent in December 2006* *to 6.4 percent in June, mainly reflecting the impact of monetary policy on price developments in the absence of supply-side and transitory shocks. The fall in inflation also reflected the rebasing of the consumer price index to September 2006, and the introduction of a new basket comprising a wider range of goods and services and revised weights, which provided a more up-to-date and representative measure of price increases[1]. However, the downward trend in inflation was reversed in July 2007 despite fluctuations up to September, largely due to the increase in fuel prices and the cost of health care services as the Government continued to broaden the cost recovery measures. Globally, oil prices increased substantially in 2007, mainly as a result of geopolitical tensions and supply constraints in the context of higher demand by China and India to support buoyant industrial production.*

1.5 The sustained increase in the annual rate of growth of commercial bank credit and the much faster growth in government expenditure were indicative of upward domestic demand pressures. The impact of these developments on inflation was, nevertheless, mitigated by the relatively tight monetary policy.

1.6 Going forward, it is evident that there is upward pressure on domestic inflation due to adverse external influences, including the projected rapid rate of price increases in South Africa in the first quarter of 2008; while the impact of exchange rate movements on domestic prices is expected to be minimal. However, it is expected that global inflationary pressures will be moderated by slower output growth in some of the major economies and higher productivity in emerging market economies. Overall, the outlook is that domestic inflation will, on average, be just above 8 percent in the first quarter of 2008, and fall close to 6 percent towards the end of the year. There are, however, upside risks to this outlook due to the possible large increase in administered prices. These include a likely increase in electricity tariffs due to regional supply shortages. Moreover, any large increase in civil service salaries will impact on aggregate demand. Consequently, the overall impact of these developments on the inflation prospects could have a considerable influence on the direction of monetary policy in the short-term.

2. MONETARY POLICY FRAMEWORK AND OBJECTIVES

2.1 The objective of the Bank's monetary policy is to achieve a sustainable, low and predictable level of inflation. This goal contributes towards the broader national objectives of sustainable economic growth and development to the extent that it promotes savings mobilisation and productive investment.

1 In general, a rebasing of the CPI with a wider and updated list of items normally results in lower inflation while an older basket is likely to have a larger inherent upward bias.

2.2 *To achieve the price stability objective, the Bank uses interest rates and open market operations to affect demand conditions in the economy and ultimately the rate of price changes. In this regard, changes in interest rates and the availability of loanable funds influence choices with respect to credit demand and saving and, in turn, the determination of aggregate demand. Credit growth is, therefore, a useful indicator of prospective demand conditions and the likely impact on inflation. It is against this background that the Bank has been specifying a range of credit growth that is consistent with the inflation objective. Although the rate of growth of credit is not an optimal measure, the Bank, like several other central banks, has relied for many years on it as a key indicator of demand conditions. Another advantage of using credit as an indicator of demand is that it is generally more timely and reliable. However, demand for credit depends not only on interest rates; it is also influenced by other developments in the economy. In Botswana, these other influences on credit growth include structural changes in the financial sector, greater competition resulting in the introduction of new loan products, the general increase in incomes and the substantial loan amounts associated with large new investment projects.*

2.3 *While changes in the financial sector and their impact on credit continue to provide useful information for policy formulation and indeed the determination of the policy stance, the Bank has made progress in developing capacity to estimate aggregate demand conditions. This process facilitates an assessment of the inflation outlook, which is the basis for the monetary policy stance. Against this background, the Bank will, henceforth, focus explicitly on the medium-term inflation forecast, which takes into account both the demand and supply side factors, as an indicator that should inform the response of monetary policy.*

2.4 *This approach also recognises the importance of the horizon over which policy changes are likely to impact on price developments. Based on the forecasting framework, this period has been assessed to extend beyond four quarters. In the short term (four quarters), the inflation outcome would have been determined by past developments or would be influenced by shocks and, therefore, cannot respond to current policy action to any significant degree. In the past, the Bank has specified annual inflation objectives in a bid to anchor short-term inflation expectations, as well as to guide the policy stance given the expected inflation path. Going forward, the Bank will specify a medium-term inflation objective that represents the Bank's view of price stability. Monetary policy will then respond to deviations from this objective as informed by the medium-term inflation forecast rather than the currently observed level of inflation or the short-term forecast. To sustain expectations of low inflation in the medium-term, and in the interest of transparency on the likely policy direction, the Bank will disclose the likely rate of inflation in both the short-term and medium-term.*

2.5 *The medium-term is defined as a rolling three-year period. This approach is facilitated by the Bank's capability to continuously forecast inflation over a defined medium-term, representing a period over which monetary policy can impact on price developments. With a continuous medium-term perspective, the* *length of the horizon over which monetary policy can be effective remains constant and reinforces the perspective that policy decisions are based on a forward-looking assessment of inflationary pressures. Indeed, the focus on a continuous horizon for the inflation objective is in line with international best practice.*

2.6 *The inflation forecast is based on the Bank's assessment of the transmission channels for price determination by economic agents. These channels include price changes due to variations of the demand/supply conditions influenced by movements in interest rates and the exchange rate[2], as well as the direct response of domestic prices to movements in the cost of imports. Prices and inflation also respond to, inter alia, shocks such as an adjustment of administered prices, consumption taxes and significant growth in domestic and foreign incomes. In addition, public expectations of the level of inflation influence price changes by firms and wage adjustments. These factors are taken into account in determining the medium-term inflation forecast on which the monetary policy stance is based. The alternative measures of inflation, namely, headline measure, 16 percent trimmed mean and exclusion method (inflation excluding administered prices), continue to be useful in highlighting sources of price changes and in explaining developments regarding inflation.*

3. INFLATION TRENDS IN 2007

3.1 *Inflation decelerated in the first half of 2007, from 8.5 percent in December 2006 to 6.4 percent in May and June 2007, and was within the Bank's annual inflation objective range of 4 - 7 percent between March and June. The 16 percent trimmed mean measure of core inflation fell from 7.6 percent in December 2006 to 6.1 percent in June 2007 and core inflation excluding administered prices also fell from 8.9 percent to 6.8 percent in the same period.*

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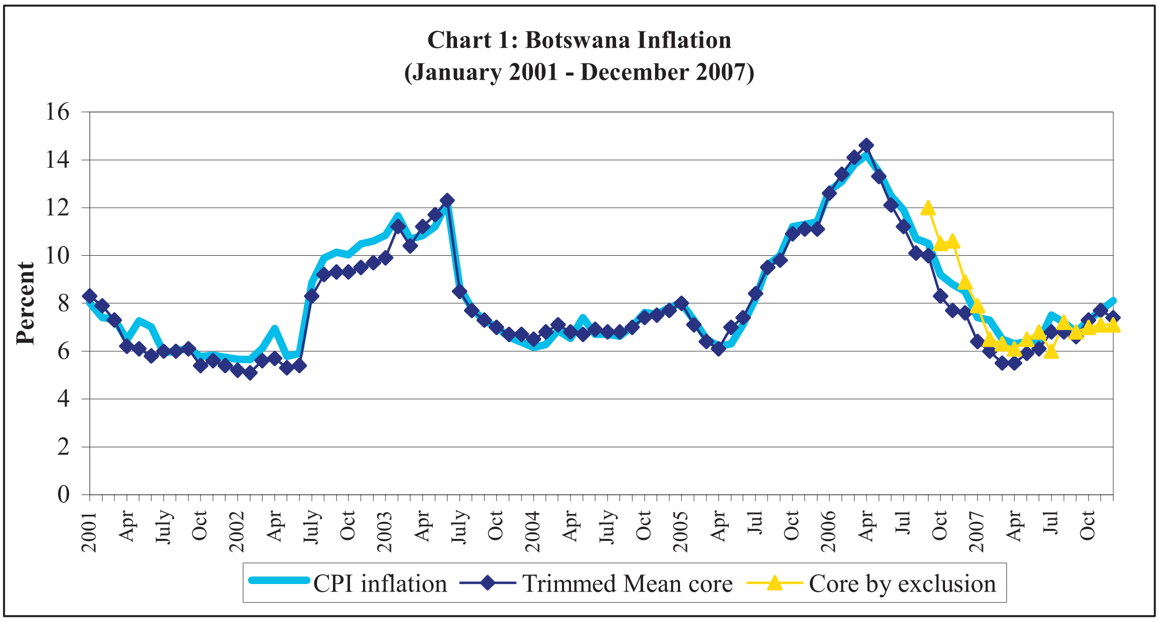
[2] *Technically, this relates to the impact of changes in real interest rates and real exchange rates on the availability of credit and domestic industry competitiveness, referred to as real monetary conditions.*

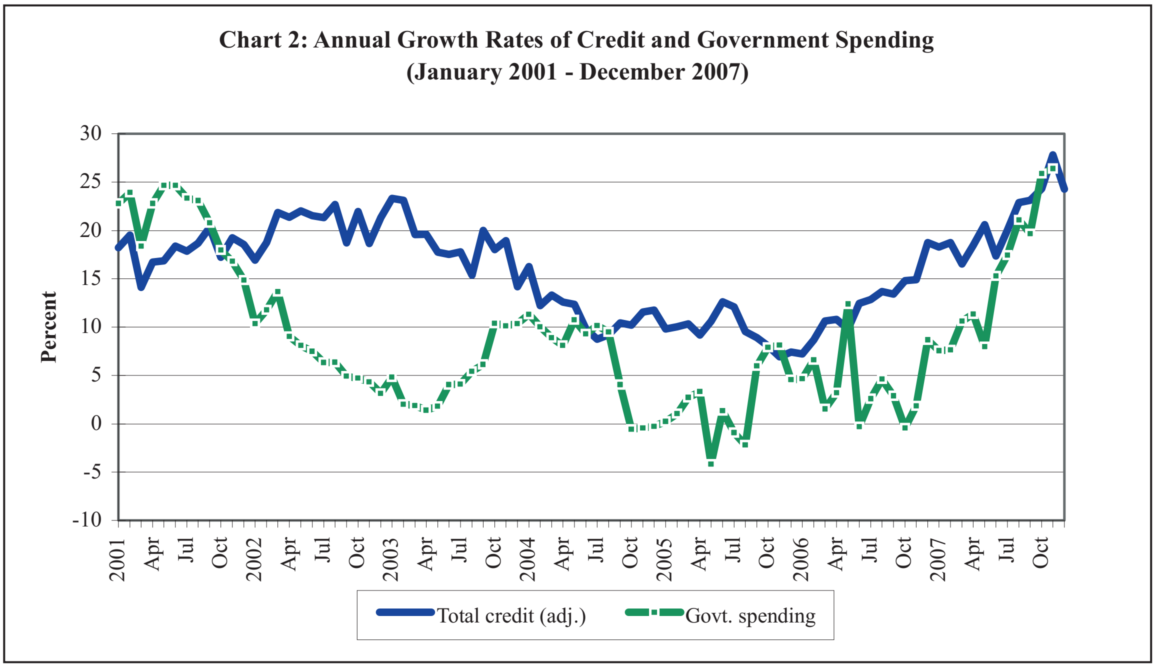


3.2 *However, inflation generally trended upwards from July 2007 due to a faster increase in the cost of food and the upward adjustment of administered prices, and was 8.1 percent in December. The core measures of inflation were also higher at 7.4 percent for the 16 percent trimmed mean method and 7.1 percent for the exclusion method (excludes administered prices). In particular, successive fuel price increases contributed 2.9 percentage points directly to inflation in the second half of the year and the increase in fees for some government health services contributed 0.3 percentage points to inflation. The overall impact on inflation of the rebalancing of Botswana Telecommunications Corporation tariffs was neutral, reflecting relatively high increases for some domestic tariffs being offset by a reduction in tariffs for international services.*

3.3 *Domestic tradeables inflation rose from 10.3 percent in December 2006 to 15.2 percent in December 2007, while, in the same period, the annual increase in the cost of imported tradeables went up from 7 percent to 7.7 percent. As a result, all-tradeables inflation rose from 8 percent to 10.3 percent, with the high rate of price increases in this category reflecting the impact of rising fuel and food prices. Meanwhile, inflation for non-tradeables fell from 9.5 percent in December 2006 to 3.4 percent in December 2007, mainly reflecting the dissipation of the impact of the large increase in some energy prices in December 2006.*

3.4 *Besides the impact of changes in administered prices and the higher cost of food, there were indications of strengthening pressures on inflation arising from domestic demand. Preliminary Gross Domestic Product (GDP) estimates for 2006/07 show output growth of 6.2 percent, which is significantly higher than the revised 0.6 percent growth for 2005/06. The higher output growth was mainly attributable to strong performance in the manufacturing, trade, hotels and* *restaurants, and transport and communications sectors, which registered growth rates of 12 percent, 16.3 percent and 20.3 percent, respectively[3]. As a result, non-mining output grew overall by 6.8 percent, compared to 3.9 percent of the previous year.*

3.5 *The faster GDP growth was, in part, linked to the acceleration in the rate of growth of both credit to the private sector and government expenditure. The rise in government spending was, in part, a result of a faster rate of project implementation, while the rapid increase in credit expansion was a combined result of the introduction of new products by commercial banks and some of the development finance institutions, the expansion of the banking sector and large, new private sector and government projects. Year-on-year growth in credit to the private sector accelerated from 18.8 percent in December 2006 to 24.3 percent in December 2007 (Chart 2). The annual increase in lending to the household sector rose from 16.7 percent at the end of 2006 to 29.4 percent in December 2007. However, the growth in business borrowing slowed from 21.8 percent to 17.3 percent.*



3.6 *The impact of government activity on demand is reflected in the estimated 32.2 percent annual increase in total recurrent and development expenditure in 2007/08 compared to 2006/07[4]. The year-on-year increase in development spending, which was reflective of the implementation of large projects, was a substantial 90.4 percent, while growth in recurrent expenditure was lower at 17.4 percent.*

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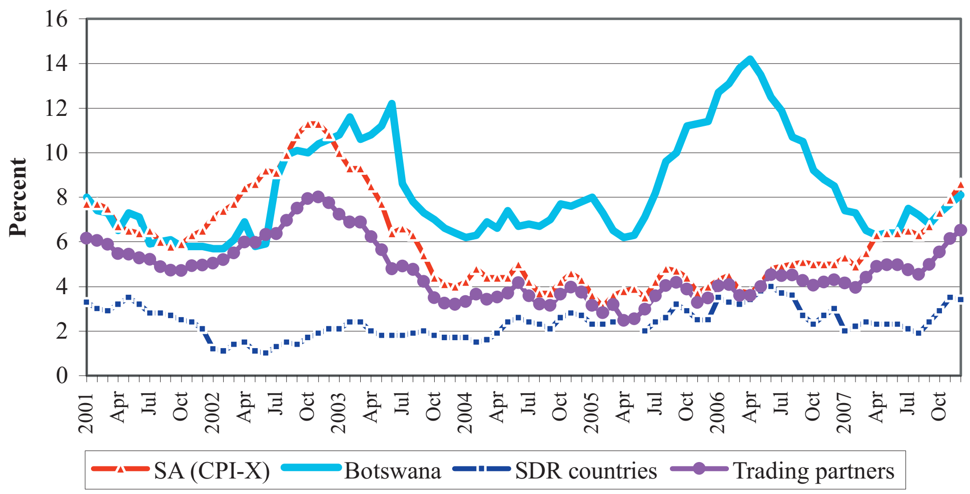
3 *The numbers are provisional and subject to revisions.*
4 *Fiscal year runs from April to March.*

3.7 *The external influence on domestic inflation was significant in 2007, largely being transmitted through the direct impact of the increase in food and fuel prices. Although world inflation rose from 3.5 percent in 2006 to 4.2 percent in 2007, the increase was restrained by a successful management of expectations globally, and relatively low production costs in the rapidly expanding Asian economies. The increase in inflation was also in the context of marginally lower world output growth of 4.9 percent in 2007 compared to 5 percent in 2006, a slowdown that was indicative of the impact of past monetary policy tightening[5]. The disruption in some of the major financial markets due to the sub-prime lending crisis in the USA also contributed to lower global GDP growth towards the end of 2007.*

3.8 *In the SDR countries[6], inflation was 3.4 percent in December 2007, moderately higher than the 3 percent in December 2006. Meanwhile, the higher cost of fuel and food had a more pronounced effect in South Africa as CPIX[7] inflation rose from 5 percent to 8.6 percent; since April 2007, it has been above that country's target range of 3 - 6 percent. Overall, the trade-weighted average inflation of Botswana's trading partner countries rose from 4.3 percent in December 2006 to 6.5 percent in December 2007. Chart 3 shows a comparison of inflation trends for Botswana and its trading partners.*

Chart 3: International Inflation
(January 2001 - December 2007)



3.9 *At the beginning of 2007, the Bank set an annual inflation objective at a level higher than the trade-weighted inflation average of trading partner countries. Therefore, to attain stability of the real effective exchange rate (REER), and*

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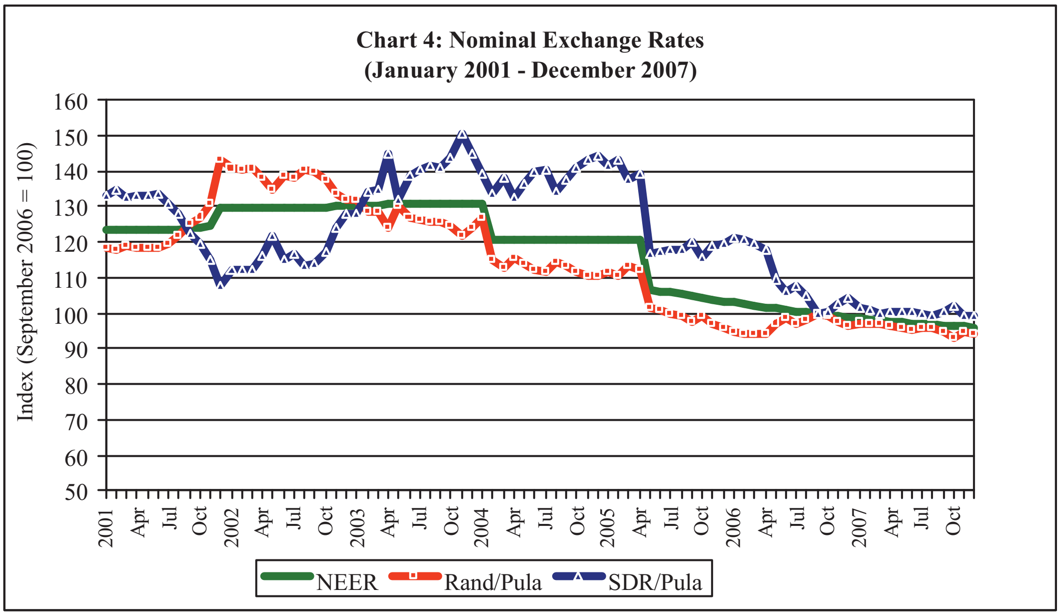
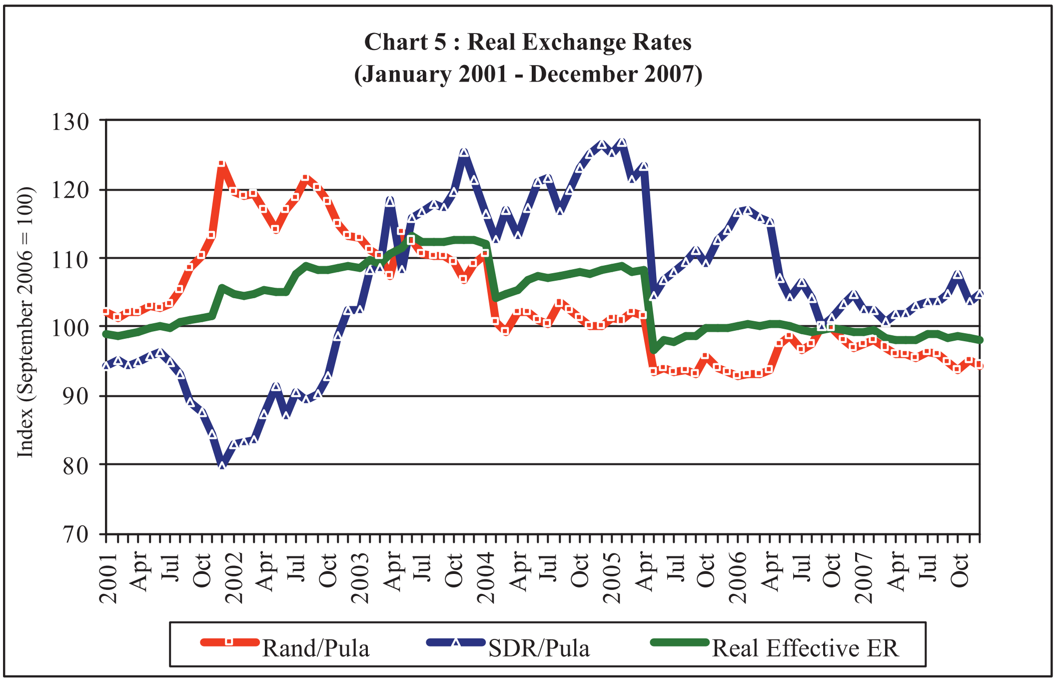
5 *World Economic Outlook as published by the International Monetary Fund (updated in January 2008).*
6 *USA, UK, Japan and euro zone .*
7 *CPIX is South Africa's consumer price index; it excludes mortgage interest rates.*

consistent with the crawling band exchange rate mechanism, the nominal effective exchange rate (NEER) of the Pula crawled downwards in 2007. This is reflected in the 2.9 percent depreciation of the NEER in the year to December 2007. In the same period, the Pula depreciated by 4.4 percent against the SDR (with a marginal 0.4 percent appreciation against the US dollar) and by 2.1 percent against the South African rand. The REER depreciated by 1.4 percent in the year to December 2007, as the downward crawl more than offset the differential between higher inflation in Botswana and that of trading partner countries.





4. MONETARY POLICY IMPLEMENTATION IN 2007

4.1 The 2007 annual inflation objective of 4 - 7 percent was set in consideration of forecast average inflation of the trading partner countries of 4 - 6 percent and anticipated higher inflation in Botswana, due to the effects of the increase in administered prices in the second half of 2006. However, the 4 - 7 percent inflation objective accommodated some of the higher level of inflation, which was due to transitory factors, while aiming for a reduction of inflation more gradually over the medium term.

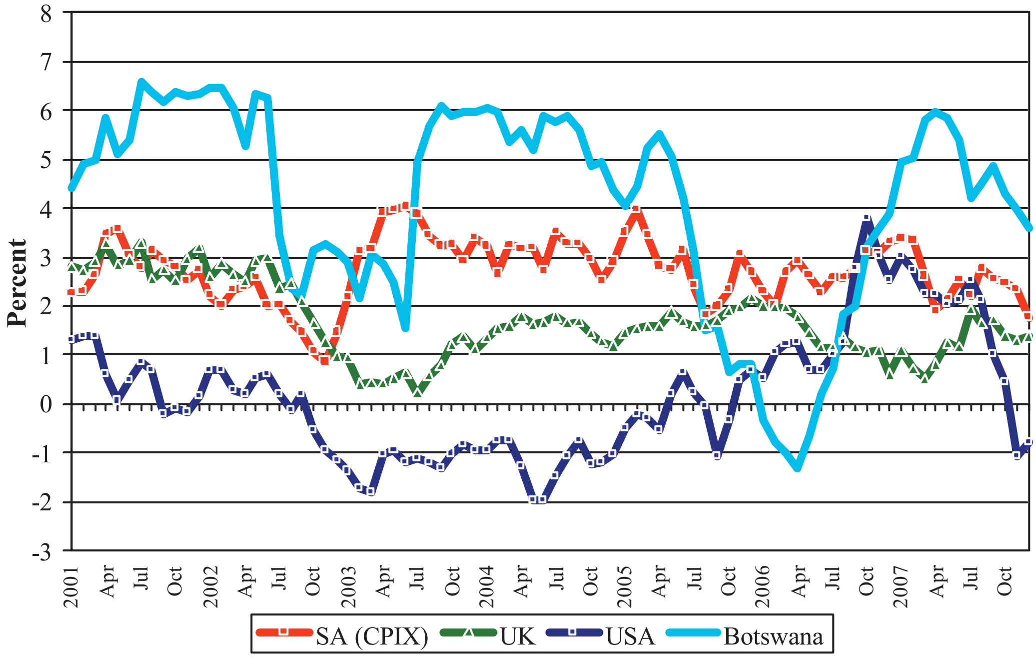
4.2 The sustained deceleration of inflation in the first half of 2007 and a positive medium-term outlook seen at the time, justified the June 2007 half a percentage point reduction of the Bank Rate to 14.5 percent. The Bank Rate was maintained at 14.5 percent for the remainder of the year, and thus monetary policy remained relatively restrictive in 2007. Inflation was within the annual objective range of 4 - 7 percent only briefly (between March and June and again in September); thereafter, it was above the range and ended the year at 8.1 percent.

4.3 The downward crawl of the nominal exchange rate was consistent with the exchange rate policy of stabilising the REER in support of the broader national objective of economic diversification through export competitiveness. Since the increase in domestic inflation matched that of trading partner countries, the result was that the inflation differential was constant during 2007. However, because the downward rate of crawl was greater than the inflation differential between Botswana and its trading partner countries, the REER depreciated by 1.4 percent in 2007.

4.4 Open market operations were supportive of monetary policy in absorbing excess liquidity in the banking system and in maintaining a desired level of interest rates which were in line with the Bank's restrictive monetary policy stance. The yield on the 3-months BoBC ranged between 11.90 percent and 12.72 percent in the period January-December 2007, while that of the 14-day BoBC ranged between 11.96 percent and 12.74 percent, with lower rates in the latter half of the year following the June 2007 easing of monetary policy. The average prime lending rate was, therefore, lower in December 2007, at 16 percent compared to 16.5 percent at the end of 2006, while the average 88-day deposit rate fell from 8.38 percent to 8.28 percent.

4.5 Real interest rates eased slightly in the twelve months to December 2007, following the decrease in interest rates in the middle of the year. Real yields on the 14-day and the 3-months BoBCs continued to move in line, both decreasing from 3.9 percent in December 2006 to 3.6 percent in December 2007. Similarly, the real prime lending rate eased marginally from 7.4 percent to 7.3 percent. At the end of 2007, the comparable international real 3-month money market interest rates were 1.8 percent, 1.4 percent, -0.8 percent and 0.5 percent for South Africa, UK, USA and the euro zone, respectively.

Chart 6: Real Interest Rates International Comparisons (January 2001 - December 2007)



5. OUTLOOK FOR INFLATION IN 2008

5.1 Global economic performance is anticipated to remain strong in 2008, with world GDP growth of 4.1 percent, which is lower than the 4.9 percent growth rate of 2007. The forecast lower expansion of world output reflects the negative impact of the sub-prime lending crisis, particularly in the USA. However, sustained buoyant demand in some of the emerging Asian countries, especially China and India, continues to support the outlook for strong global growth.

5.2 Buoyant expansion of world output comes at a time of inflationary pressures arising from the significant increase in primary commodity (particularly oil) and food prices. Nevertheless, world inflation is expected to fall from 4.2 percent in 2007 to 3.4 percent in 2008, on account of competitiveness in the goods market, and productivity gains that are associated with technology improvements. This is complemented by relatively low production costs in the fast expanding Asian economies. Furthermore, monetary authorities have largely been successful in managing inflation expectations, through more transparent policy frameworks and, until mid-2007, preemptive policy tightening by central banks of major economies. This has helped moderate expectations-induced inflationary pressures.

5.3 Average inflation in the SDR countries is forecast at 2.1 percent in 2008. While South African CPIX inflation is similarly forecast to decrease, it is expected to end the year marginally above the upper end of the 3 - 6 percent target range. Overall, it is expected that the recent upward pressure on domestic inflation due to price developments in South Africa, particularly relating to the increase in the cost of food and fuel, will ease in the latter part of 2008. Moreover, the cumulative South African Reserve Bank's 2 percent increase in interest rates between June and December 2007 is expected to moderate the rate of price increases in that country in the medium-term, thus contributing to lower pressure from foreign prices on domestic inflation.

5.4 Domestically, there are upward demand pressures associated with the sharp acceleration in the growth of both credit to the private sector and government expenditure. These trends are partly a result of a significant increase in private sector and government projects that contributes to the forecast improvement in real economic activity which, in turn, pose an upside risk to inflation alongside the prospects of likely supply-side bottlenecks that can lead to an increase in input prices. The possible salary increase for civil servants, which is likely to be emulated by the private sector as they seek to maintain remuneration differentials, would add to domestic demand as well as production costs and, consequently, upward pressures on inflation. Moreover, there is a likelihood of a significant increase in some administered prices, particularly electricity tariffs in the light of *the 14.2 percent tariff increase by Eskom (Botswana's major power supplier) during the 2008/09 financial year.*

5.5 The rate of crawl of the exchange rate, which is based on the differential between the Bank's inflation objective and forecast inflation of trading partner countries, is not expected to result in a substantial nominal exchange rate adjustment during 2008. For this reason, there should be no upward inflationary pressures resulting from the crawl of the Pula exchange rate. Overall, inflation is expected to remain above the price stability objective and to average approximately 8 percent in the first quarter of 2008, before decreasing to just above 6 percent in the fourth quarter. The Bank's monetary policy stance is, therefore, geared towards ensuring the envisaged decline in inflation in the medium term, consistent with the price stability objective.

6. MONETARY POLICY STANCE IN 2008

6.1 As indicated earlier, the objective of monetary policy is price stability, which also contributes towards achieving a stable REER through attaining a level of inflation that is in line with the average inflation of trading partner countries. To the extent that Botswana's inflation objective is higher than the average inflation of trading partner countries, the nominal exchange rate will crawl downwards to attain stability of the REER. For 2008, the forecast inflation range for trading partner countries is 4 - 6 percent, which approximates the Bank's medium-term inflation objective of 3 - 6 percent.

6.2 Given the current monetary policy stance and the forecast influence on price developments, it is anticipated that domestic inflation will converge to the medium-term objective in 2009. However, the upside risks to inflation, such as a possible increase in administered prices and a wage-induced increase in inflation, pose challenges for monetary policy in the short term in order to ensure the achievement of the medium-term objective. Accordingly, the Bank will respond in a timely manner to any significant deviations of the medium-term inflation forecast from the 3 - 6 percent objective. This policy stance should continue to restrain demand pressures and underscore the Bank's commitment to achieving the medium-term price stability objective; it should also anchor inflation expectations. The Bank will also implement an appropriate rate of crawl for the NEER, consistent with the crawling band exchange rate mechanism, with the objective of maintaining the stability of the REER.

7. CONCLUSION

7.1 Inflation declined in the first six months of 2007, but rose in the latter half of the year due to large increases in administered prices, notably fuel and health services, as well as the escalating cost of food. By the end of the year, inflation had risen to 8.1 percent and was above the upper end of the 4 - 7 percent inflation objective.

7.2 *Global economic expansion slowed marginally in 2007, and is forecast to decelerate further in 2008, while the increase in inflation in 2007 is expected to be reversed in the coming year. In the short term, however, the forecast increase in South African inflation, the continuing high levels of growth of private sector credit and government expenditure in Botswana and any wage-induced increase in demand, will add to domestic inflationary pressures.*

7.3 *With inflation forecast to remain above the price stability objective in the short term, the challenge for monetary policy is to entrench expectations of low and sustainable inflation in the medium term, through timely responses to economic and policy developments. Overall, the Bank will conduct a forward-looking and forecast-based monetary policy, with a view to ensuring that inflation falls within the desired medium-term objective of 3 - 6 percent. To this end, the Bank remains committed to responding appropriately to all economic and financial developments to keep inflation under control.*

7.4 *The Bank's response will be consistent with the monetary policy framework, which, from 2008, has been refined in the light of progress made in understanding the transmission path of monetary policy. Specifically, the Bank will, going forward, focus only on a rolling three-year medium-term inflation objective of 3 - 6 percent. Furthermore, the Bank will use the more inclusive and representative medium-term inflation forecast as the intermediate target, in place of the less inclusive annual rate of credit growth.*