BANK OF BOTSWANA

MONETARY POLICY STATEMENT 2002

Mid-Year Review

1. INTRODUCTION

1.1 The Monetary Policy Statement (MPS) released in February 2002 specified several objectives that the Bank of Botswana intended to meet during the year. The purpose of this mid-year review of the MPS is to ascertain the extent to which the objectives have been met as at the middle of the year; to review the outlook for economic and financial trends for the remainder of the year; and, to evaluate the need or otherwise for a change in the stance of policy.

1.2 The MPS stated that, "On the basis of currently available forecasts of inflation in South Africa and the SDR countries for 2002, the Botswana inflation necessary to achieve general stability in the real effective exchange rate (REER) would be in the range of 4 – 6 percent". The inflation objective was expressed as a range to reflect possible outcomes of forecasts, current at the time, for South Africa and the SDR countries.

1.3 To achieve the inflation objective, monetary policy has been focused on the control of an intermediate target, the growth rate of credit to the private sector, while it also takes account of the growth in government spending. These two factors are considered to be the main determinants of aggregate demand in Botswana and, therefore, the main domestic causes of inflationary pressures arising from the imbalance between aggregate supply and expenditure. For 2002, the desired range of credit expansion is 12.5-14.5 percent.

2. THE OUTTURN FOR THE FIRST HALF OF 2002

2.1 The domestic economic and financial outturn for the first half of 2002 has generally been as expected in the MPS. Inflation has been largely stable, fluctuating around the upper level of the desired target range. Credit growth was below or within the target range for the first half of the year, although the trend has been upward and underlying credit[1] growth has been above the target range. While the Bank maintained a tight monetary policy stance, domestically generated inflation rose in the first six months of the year but was moderated by the slowdown in imported inflation.

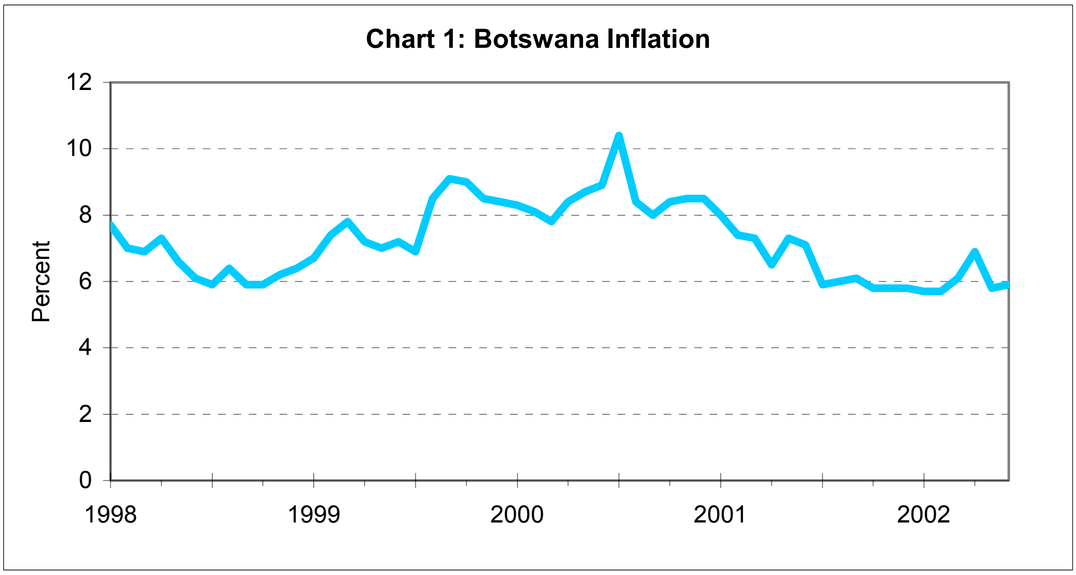
2.2 Although world economic performance improved in the first half of 2002 compared to last year, the recovery is now estimated to be slower than projected at the beginning of the year. Global inflation was largely stable during the first six months of 2002,

[1] Underlying credit excludes loans to certain large companies acquired in 1999 and paid off in 2001 using offshore funds. A substantial overdraft granted to one large company to pay tax and outstanding for ten days is also excluded from the credit growth figures.

leading most of the major central banks to maintain a relatively stimulative monetary policy stance in order to support the current growth trend.

(a) ***Domestic Inflation***

2.3 *Inflation[2] eased further in the early months of the year, moving from 5.8 percent in December 2001 to 5.7 percent in January and February 2002, the lowest rate experienced since February 1985 when it was 5.4 percent. It rose again to a high of 6.9 percent in April before falling back to under 6 percent in June (see Chart 1). The main contributors to inflation during the first half of 2002 were increases in the cost of food, alcohol and tobacco, and housing. The rise in food prices was due to a number of factors, including the shortage of cereal products resulting from drought conditions in Southern Africa, higher international grain prices and the depreciation of regional currencies against the US dollar. Housing costs were pushed up by the increase in Botswana Housing Corporation (BHC) rentals, which was the cause of the temporary jump in inflation in April.*



2.4 *The overall stability of inflation was a combined result of higher inflation for domestically produced tradeable goods and a slowdown in price increases for non-tradeables and imports. Inflation for domestic tradeables rose to 8.2 percent in June 2002 from 5.9 percent in December 2001, while that for non-tradeables slowed during the same period to 6.9 percent from 8.3 percent. In the light of lower global inflation and the modest nominal appreciation of the Pula in the last quarter of 2001, imported inflation also slowed, to 3.8 percent in June 2002 from 4.6 percent in December 2001. The relative trends in inflation for domestic and imported tradeables partly reflect the nature of commodity classification within these categories. For instance, a major contributor to rising domestic tradeables inflation has been cereal prices, for which annual inflation was 11.9 percent in June, compared to 4.4 percent at the beginning of the year. Notwithstanding their classification as domestic*

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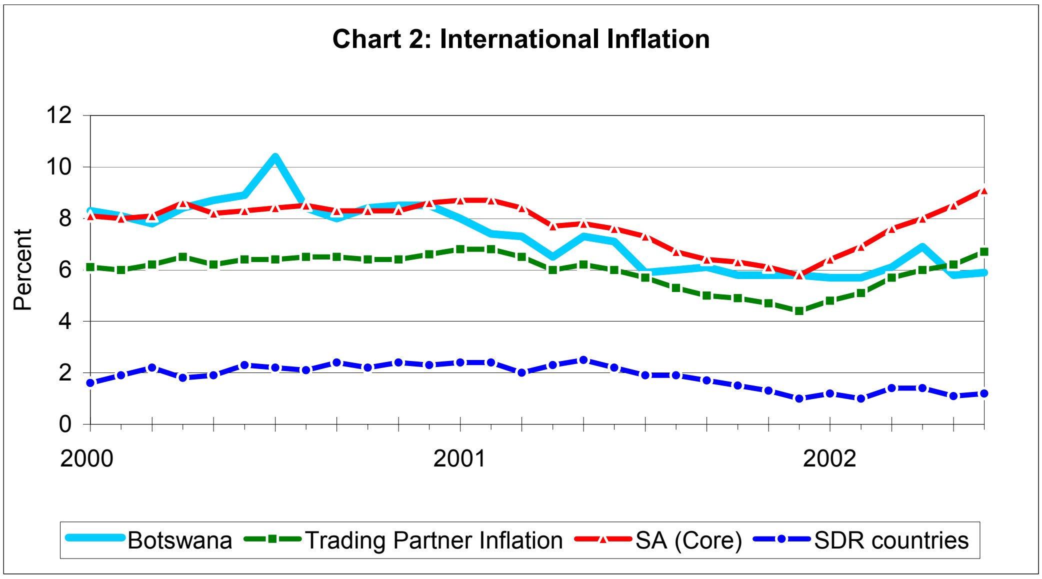
[2] Unless otherwise indicated, all inflation rates and growth rates are year-on-year changes.

tradeables, cereals are mostly imported and their prices would normally reflect this fact.

2.5 *The overall or conventional headline measure of inflation is subject to the influence of volatile or large price fluctuations, such as those due to seasonality or administered price changes, that may not warrant an immediate policy reaction. Hence the Bank is developing a measure of core inflation that is more appropriate as an indicator of underlying inflationary pressures and, as such, a better guide for monetary policy. Initial indications from these measures of core inflation are that inflationary pressures in recent months have been somewhat less than those indicated by the headline measure of inflation.*

(b) ***International Inflation Trends***



2.6 *Inflation in Botswana's trading partners was on average higher in the first half of 2002 at 6.2 percent compared to 4.1 percent at the end of 2001 (chart 2). While in the SDR economies inflation was unchanged at 1.0 percent in June 2002, the same as at the end of 2001, South African inflation increased sharply during this period. South African core inflation was 9.1 percent in June 2002, compared to 5.8 percent in December 2001, while CPIX*[3] *was 9.8 percent, well above the South African Reserve Bank's target of 3 - 6 percent for 2002 and 2003; the main cause of this was the lagged impact of last year's depreciation of the rand as well as a rise in oil prices and labour costs.*

(c) ***Domestic Credit***

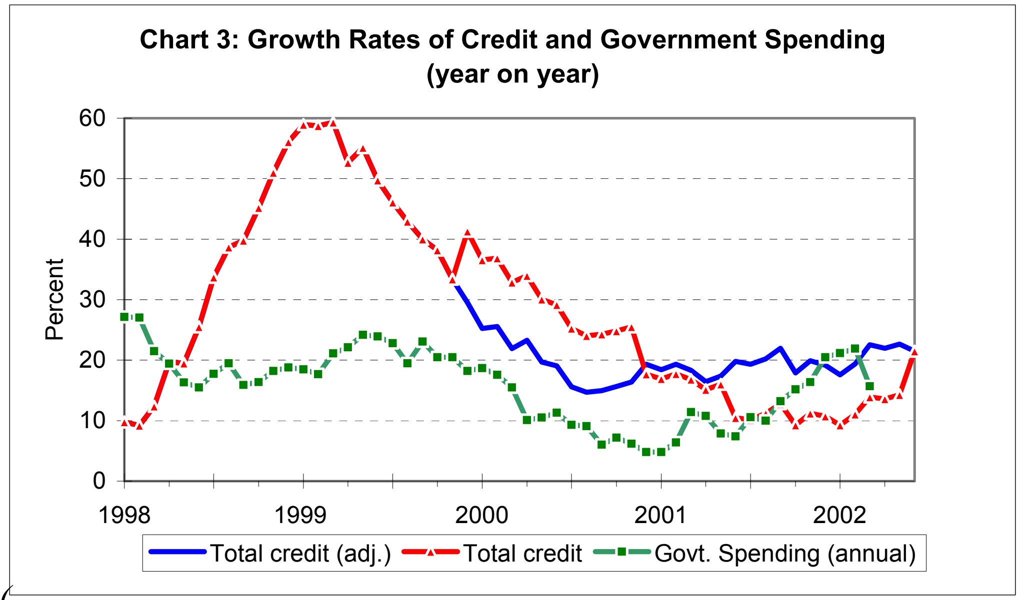
2.7 *The growth of total bank credit rose to an average of 13.9 percent during the first half of 2002 (Chart 3) compared to an average growth rate of 13.2 percent in 2001. The growth rate of credit is, however, considerably higher if credit is adjusted for the impact of the extension and subsequent early repayment of loans, using offshore funds, by certain large borrowers. If these loans are excluded the average annual*

[3] CPI for metropolitan and other urban areas excluding mortgage interest rates.

credit growth in the first half of 2002 was 20.9 percent, higher than its average growth of 18.3 percent in 2001. Within the total, the growth rate of credit extended to private sector businesses averaged 11.7 percent during the first half of 2002 or 24.6 percent after adjustment, while lending to households grew on average by 18.7 percent over the same period.

(d) ***Government Expenditure***

2.8 *Compared to 2001, government expenditure in 2002 is more expansionary. For the three months to March 2002 expenditure was 17.1 percent higher than for the corresponding period last year, while expenditure for the whole fiscal year ending March 2002 was 15.7 percent higher than in fiscal year 2000/01, against a growth rate of 11.4 percent in the previous fiscal year.*



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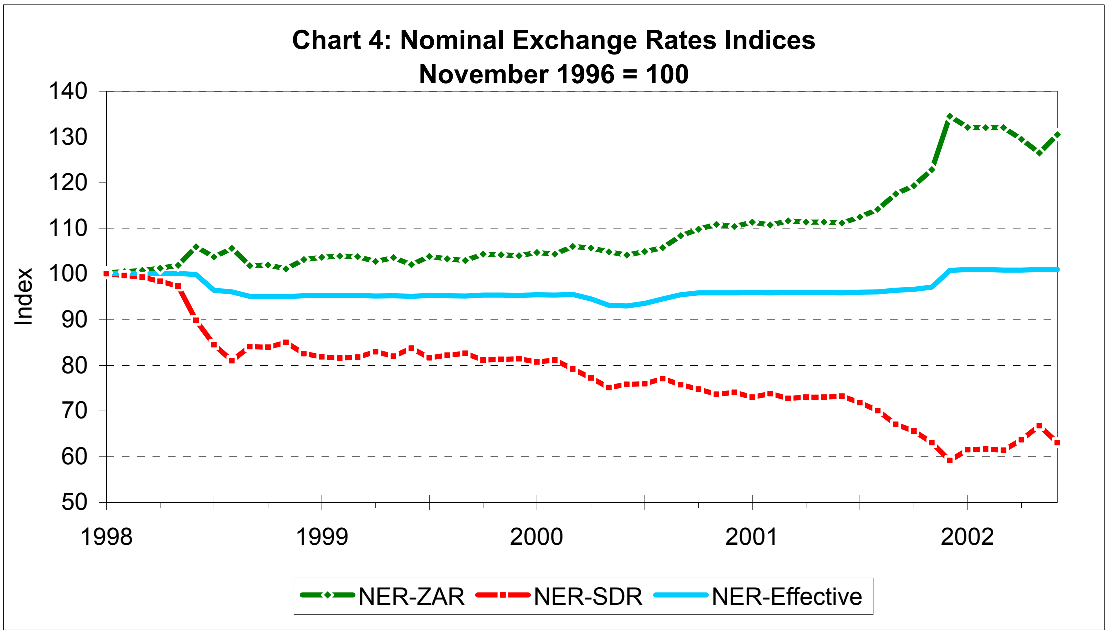
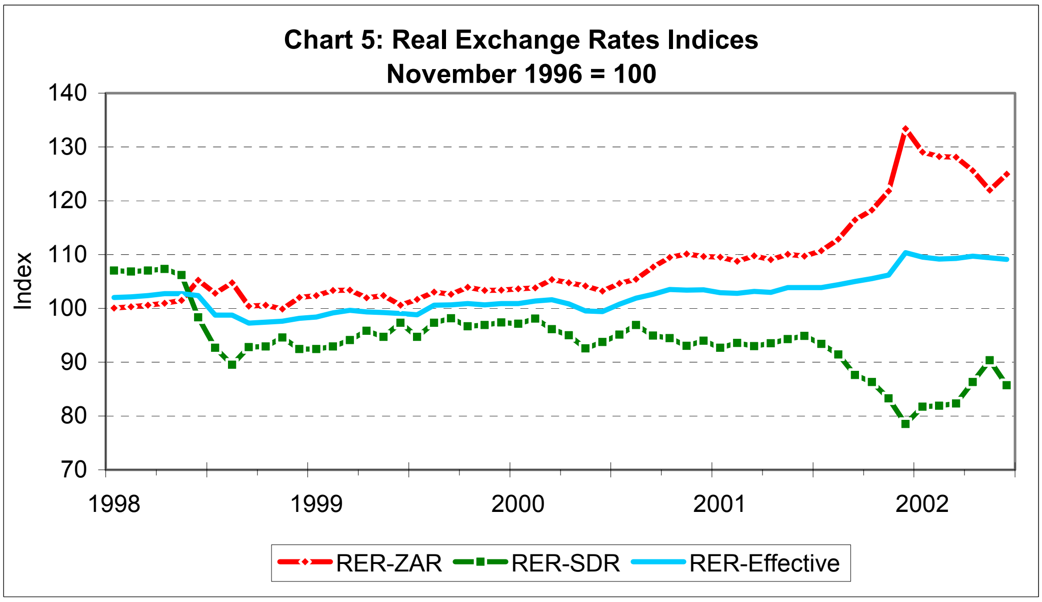
(e) ***Nominal Exchange Rates***

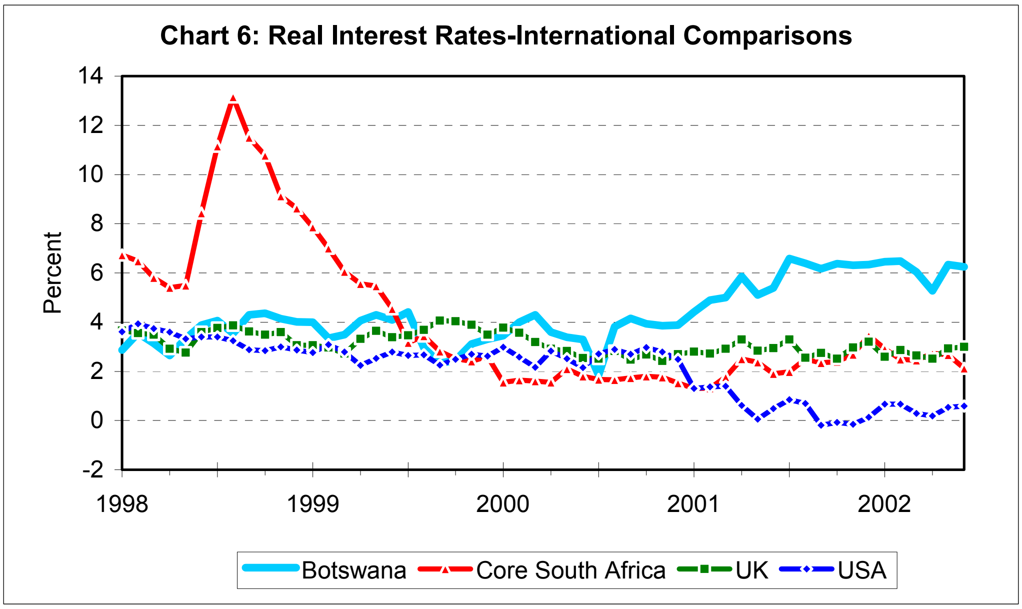
2.9 *Following its sharp depreciation towards the end of 2001, the South African rand recovered during the first half of 2002. As a result of the link to the rand through the currency basket, the Pula also strengthened against the major international currencies, appreciating by 6.6 percent against the SDR and by 12.1 percent against the US dollar. Against the rand, however, the Pula depreciated by 3.0 percent over the same period. As these movements against the different currencies in the basket were generally offsetting, the trade-weighted nominal effective exchange rate of the Pula was largely unchanged, appreciating by only 0.2 percent.*



(d) ***Real Exchange Rates***

2.10 *The real effective exchange rate of the Pula has also been relatively stable during the first half of the year, depreciating by 1.2 percent, which reflected stability in the nominal effective exchange rate and inflation in Botswana that was moderately below the average in trading partner countries. The Pula depreciated by 6.7 percent in real terms against the rand and strengthened by 9.3 percent against the SDR.*





3. ***MONETARY POLICY IMPLEMENTATION DURING THE FIRST HALF OF 2002***

3.1 *The 2002 Monetary Policy Statement stated that, "Looking ahead, the task of monetary policy more generally will be to ensure that the reduction in inflation that was achieved towards the end of 2001 is sustained". As noted earlier in this note, inflation stabilised around the upper level of the target range of 4 – 6 percent during the first half of this year. Underlying credit growth, however, remains well above target and government spending continues to be expansionary. In light of inflationary pressures due to the acceleration in credit growth and government expenditure as well as the rise in inflation in South Africa, monetary policy has remained tight, with the Bank Rate maintained at 14.25 percent. Other interest rates were also broadly stable, reflecting the unchanged monetary policy stance; the nominal three-month BoBC rate rose to 12.51 percent in June 2002 from 12.21 percent at the end of 2001.*

3.2 *As both nominal interest rates and inflation were relatively stable, real interest rates varied little, with the real three-month BoBC rate declining to 6.2 percent in June 2002 from 6.3 percent at the end of last year. Real interest rates were also generally stable internationally during the first half of 2002, indicating the unchanged policy stance in the major economies and small changes in inflation. At 6.2 percent the real BoBC rate is substantially higher than real money market rates of 0.6 percent in the USA, 3.0 percent in the UK, and 2.1 percent in South Africa.*

4. ***PROSPECTS FOR INFLATION IN THE SECOND HALF OF 2002 AND POLICY IMPLEMENTATION***

(a) ***Domestic Factors***

4.1 *The growth rates for both commercial bank credit and government expenditure are higher than desirable and therefore risk contributing to inflationary pressures.*

However, demand is likely to be curtailed by the introduction of VAT in July and the associated reduction in real disposable incomes.

4.2 Several administered prices (rentals, electricity, water and rail) have already been raised, but mostly by relatively small amounts. Except for fuel, for which a price increase might lead to an increase in public transport fares, no further changes to administered prices are expected during the remainder of 2002.

4.3 The introduction of VAT in July has had a significant impact on headline inflation, which rose sharply to 8.8 percent from the June level of 5.9 percent. The increase of 3.2 percent in prices between June and July compared to an average monthly increase of 0.5 percent over the previous twelve months provides evidence to conclude that the higher than trend increase was largely due to the introduction of VAT. Nevertheless, the initial impact of VAT on prices was at the lower end of expectations. Although there may still be further tax-related price changes over the next several months, it is likely that the bulk of the VAT pass-through has already occurred. It is also possible that some of any further tax effects could be offset by adjustments to earlier increases resulting from competitive pressures, particularly in instances where the tax may have been inappropriately applied.

*(b) **External Factors***

4.4 The global economy has recovered somewhat after last year's slowdown. However, initial forecasts of a robust recovery are likely to be revised downwards in the light of more recent disappointing growth rates in the USA, the Euro zone and Japan. Slow growth will also act to contain possible inflationary pressures. While the price of oil has stabilized, there are risks that it may rise as a result of any conflict in the Middle East, and this could lead to a hike in inflation. For the SDR countries, inflation is forecast to be 1.4 percent in the second half of the year and 1.2 percent for the whole year.

4.5 In South Africa, it is expected that inflation will peak at just over 10 percent in the third quarter of the year and start declining thereafter, to around 9 percent by the end of the year, due to the impact of monetary policy tightening and the recovery of the rand,

*5. **MONETARY POLICY STANCE IN THE SECOND HALF OF 2002***

5.1 The 2002 Monetary Policy Statement set a target range of 4 – 6 percent for Botswana inflation necessary to maintain real effective exchange rate stability. The target range was based on forecast weighted average inflation of 5.1 percent for trading partner countries. As at the end of June 2002, the weighted average inflation for trading partner countries was 6.3 percent while the revised forecast for the year is 6.5 percent. While both the actual outturn and the revised forecasts would imply an upward revision of the target range of inflation consistent with real exchange rate stability, there are strong reasons to keep it at its current level for the remainder of the year. The first is that the principal reason for the upward revision of the forecast is higher inflation in South Africa, and, as noted earlier, the increase is expected to be short-lived given the recovery of the rand and the commitment of the authorities to eventually achieve prescribed targets. A further reason for maintaining the current *desired range is that lower inflation in Botswana compared to trading partner countries will help to reverse the undesirable appreciation of the real exchange rate that occurred in 2001.*

5.2 The Bank will, therefore, maintain the target range of 4 – 6 percent stated in the 2002 Monetary Policy Statement while the range for the growth rate of credit to the private sector that is compatible with achieving this inflation outcome is also maintained at 12.5 – 14.5 percent.

5.3 As a result of the July increase in inflation following the introduction of VAT, inflation is currently above the upper end of the target range. However, this will be a one-off, temporary rise in the inflation rate as long as incomes, in both the public and private sector, are not adjusted upwards to compensate for this increase in taxes. In these circumstances, where the underlying rate of inflation (i.e., excluding the tax effect) has not risen, a monetary policy response is not needed.

*6. **SUMMARY AND CONCLUSIONS***

6.1 Inflation has generally been stable during the first half of 2002 and was lower than in 2001. However, inflation benefited mostly from lower cost increases for imports while prices of domestic tradeables accelerated, although this appears to be largely due to the rise in the cost of cereal products, reflecting the shortage of grains in the region and international price trends rather than domestic demand pressures.

6.2 The outlook is that inflation in the major industrial economies is likely to remain low and stable for the rest of the year. Nevertheless, higher South African inflation is likely to result in a rise in imported inflation. There is also continuing uncertainty about oil prices in light of the ongoing conflict in the Middle East. Domestically, inflationary pressures are likely to remain as a result of the higher than desirable rates of growth in both government spending and commercial bank credit, as well as the possible second round effects of the introduction of VAT, although these may be offset to some extent by the lower disposable incomes that will result from VAT.

6.3 In the circumstances, the Bank will continue to monitor inflation trends very closely, especially over the coming months, for any signs that the underlying rate of inflation is increasing, either as a result of the introduction of VAT or from increasing demand pressures. The task for the Bank is to ensure that the stance of monetary policy is appropriate to maintaining low and stable inflation in both the short and medium term.