BANK OF BOTSWANA

MID-TERM REVIEW OF 2003 MONETARY POLICY STATEMENT
August 22, 2003

1. Introduction

1.1 The mid-term review of the 2003 Monetary Policy Statement (MPS) has three main objectives. First, it presents a progress report on the extent to which the objectives of monetary policy, outlined in February 2003, have been achieved half way through the year; second, based on the assessment of progress, it examines the prospects for the financial and economic outturn for the remainder of the year and, depending on the prognosis, it evaluates whether or not there is need for a change in the policy stance in the remaining period of the year; and third, it informs stakeholders at mid-year of key considerations on policy formulation.

1.2 In setting its inflation objective for 2003, one of the Bank's primary considerations was inflation in trading partner countries, which was forecast at 5.7 percent for 2003. In light of this forecast, the Bank maintained the range of 4 – 6 percent for the desired level of inflation in 2003. The inflation range was intended to assist in regaining some of the competitiveness lost in 2002, and to maintain low inflation in light of concerns about the risks of a further VAT-induced increase in inflationary expectations. Furthermore, it was felt that underlying inflation (excluding the impact of VAT), remained close to the upper end of the desired range, thereby making the 4 – 6 percent range a feasible objective for underlying inflation.

1.3 Since the main objective of monetary policy is to control demand-induced inflation, the Bank focuses on the rate of growth of commercial bank credit, which contributes to domestic demand pressures and is subject to the influence of monetary policy. The Bank also focuses on the level of government spending that is considered non-inflationary given that the Government accounts for a large component of consumption expenditure and investment.

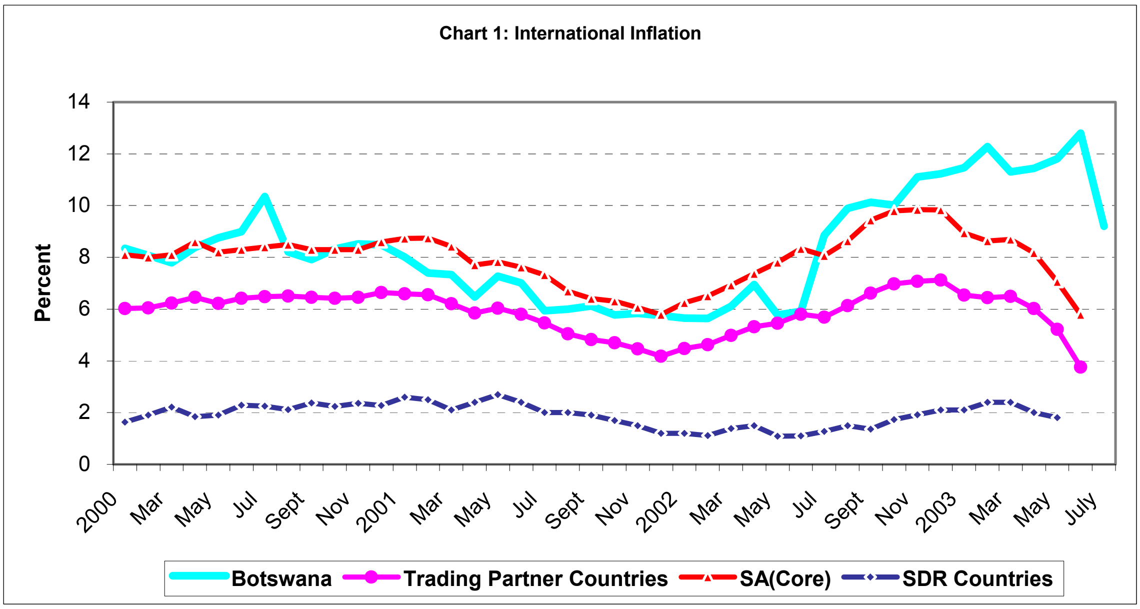
2. Outturn for the first half of 2003

2.1 In the first half of the year, annual inflation varied between 11.3 percent and 12.8 percent (Chart 1), and fell to 9.2 percent in July. After excluding the impact of VAT, inflation was close to the expected range stated in the 2003 MPS. Domestic credit maintained a downward trend over the period, falling within the desired range in June (13.9 percent) and averaging 15.3 percent for the first half of the year, down from an average of 20.8 percent of the second half of 2002. Growth in government spending also continued to slow; it *averaged 11 percent in the first quarter of 2003, compared to 22.2 percent registered in the same period last year.*

2.2 *World economic growth was slower than expected in the first half of 2003, due mainly to weak business and consumer confidence resulting from tension in the Middle East and uncertainty about world economic growth prospects. World output is estimated to have grown by a lacklustre 1.7 percent in the second quarter of 2003, down from 2.3 percent in the first quarter. Expectations are for a recovery in global economic activity in the second half of the year. Meanwhile, and consistent with expectations, global inflation slowed in the first half of 2003, reflecting, in part, low international energy prices and sluggish world economic performance. Global inflation is expected to remain low and stable during the remainder of the year.*

(a) International Inflation

2.3 *Average inflation in trading partner countries*[1] *declined to 3.8 percent in June 2003 from a revised 7.1 percent in December 2002 (Chart 1). South African core inflation declined from a revised 9.8 percent at the end of 2002 to 5.8 percent in June 2003, while headline inflation fell from a revised 12.4 percent to 6.7 percent in the same period. The fall in South African inflation was due mainly to the recovery of the rand, lower oil prices following the end of the war in Iraq and an improvement in inflation expectations*[2]*. Meanwhile, SDR inflation remained stable at around 2 percent in the same period.*



[1] South Africa and SDR countries (Japan, USA, UK and the Euro zone).

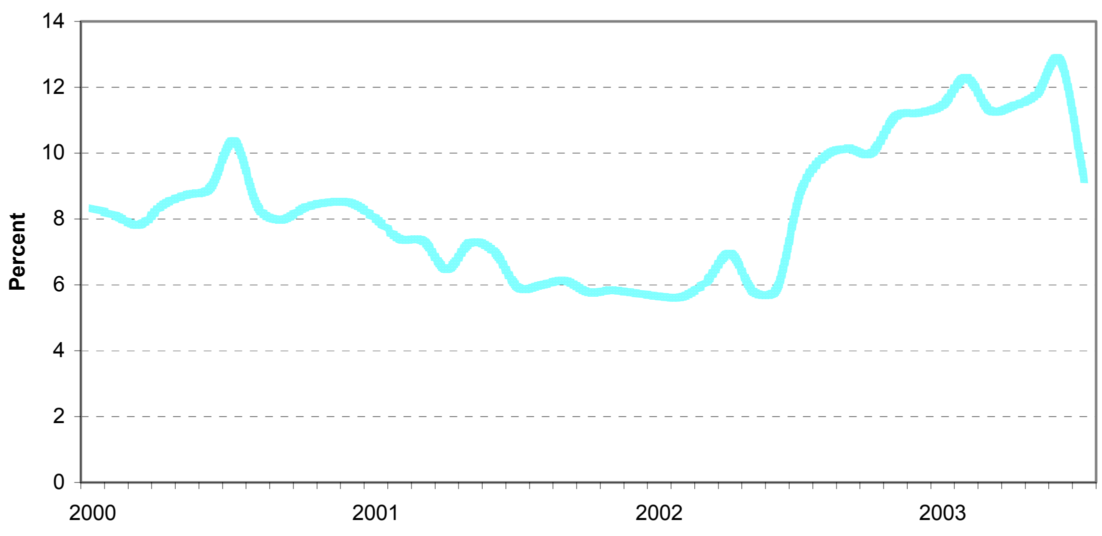
[2] South African inflation was revised downwards from January 2002 to March 2003 to correct an error detected in the CPI.

(b) Domestic Inflation

2.4 *The rise in inflation from 11.2 percent in December 2002 to 12.8 percent in June 2003 was due to a combination of domestic factors that offset the favourable external trends. Besides the increase in the cost of some food items, prices of motor vehicles rose sharply in January and April 2003. There was also an increase in Botswana Housing Corporation (BHC) rentals in June. Inflation then fell to 9.2 percent in July as the impact of the introduction of VAT in July 2002 dropped out of the calculation.*

2.5 *The increase in inflation in the first half of the year was also reflected in the cost of both tradeables and non-tradeables. Prices of imports, which rose by 8.2 percent in January, increased year-on-year by 11.3 percent in June. A similar trend was evident with respect to prices of domestic tradeables and non-tradeables. The cost of domestic tradeables was largely influenced by the rise in food prices (mainly cereals), whereas the increase in BHC rentals explained most of the rise in the cost of non-tradeables, especially between May and June 2003, when non-tradeables inflation rose substantially from 10.6 percent to 14.6 percent.*

Chart 2: Botswana Inflation

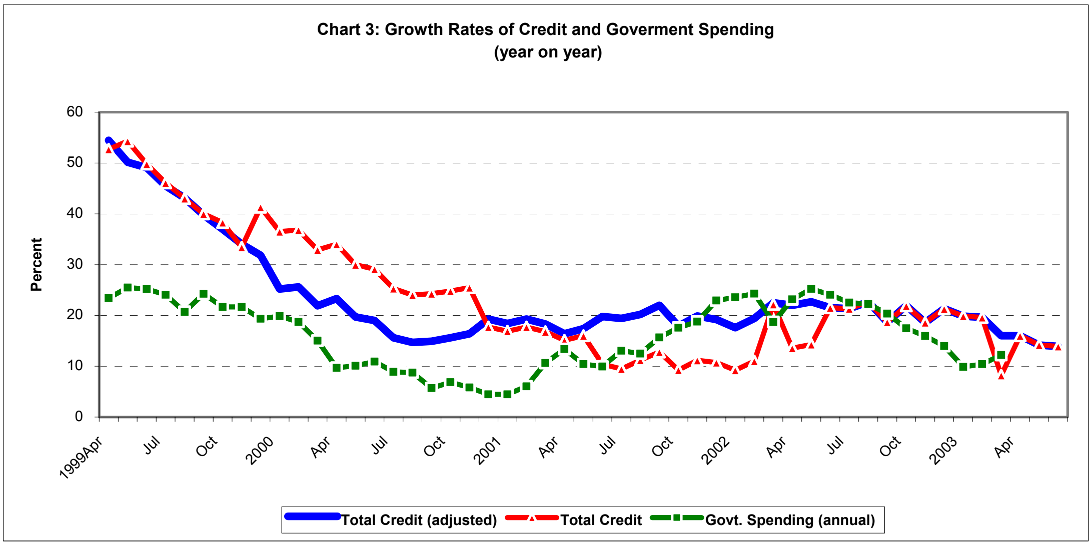


(c) Domestic Credit

2.6 *The growth of total commercial bank credit slowed to an average of 15.3 percent in the first six months of the year, from 21.3 percent at the end of 2002 and an average of 18 percent in 2002 (Chart 3). When adjusted for lumpy borrowing and repayments, average credit growth for the six months to June 2003 was 16.6 percent, or 4.4 percentage points lower than comparable figures for 2002. Year-on-year credit growth in June 2003 was 13.9 percent,* *thus bringing credit growth within the range of 12 – 14 percent that the Bank considers consistent with its inflation objective. The growth rate of adjusted credit in June was the lowest since March 1998.*

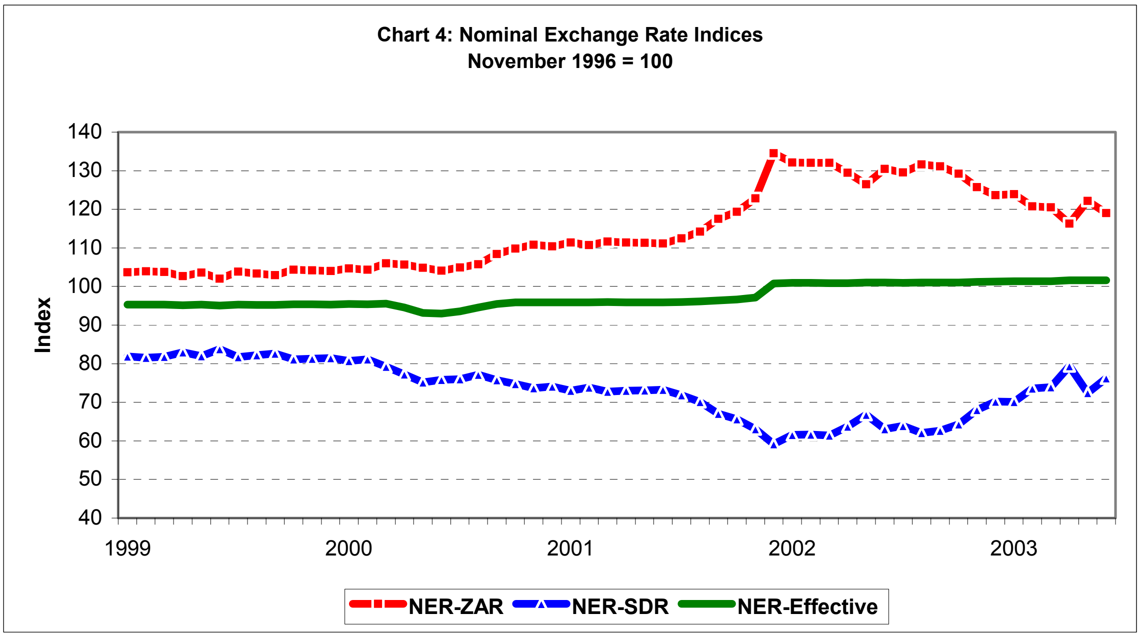
(d) Government Spending

2.7 *In the first quarter of 2003, government expenditure was 9.7 percent higher than in the comparable period of 2002 (Chart 3). For the 2002/03 fiscal year, government spending rose by 12.4 percent year-on-year (a lower rate than the 18.7 percent of the 2001/02 fiscal year), thereby giving a more desirable balance between monetary and fiscal policies in restraining aggregate demand pressures for the remainder of 2003.*



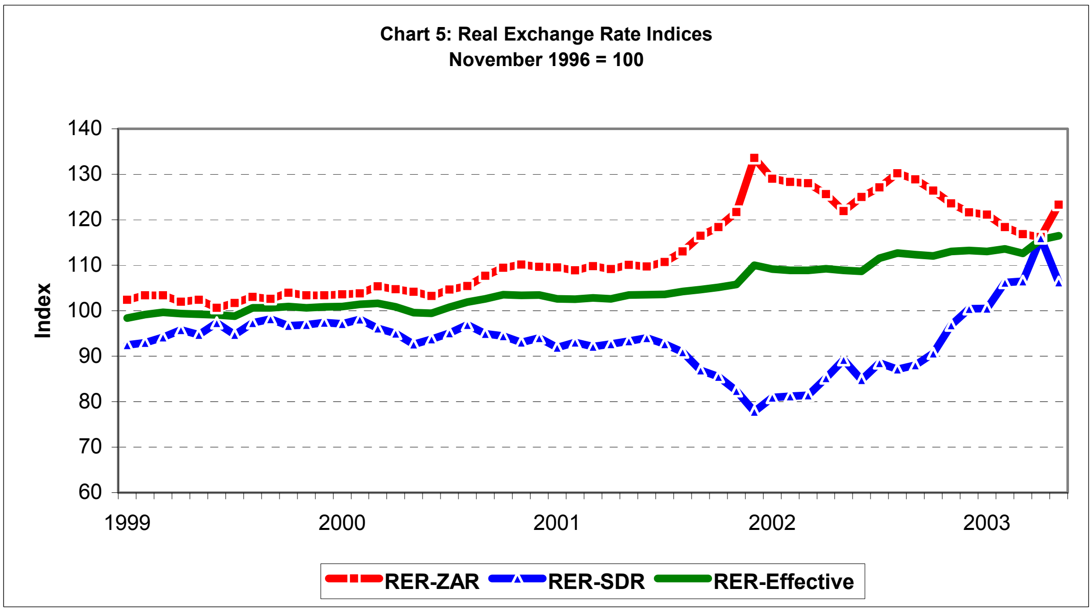
(e) Nominal Exchange Rates

2.8 *The Pula appreciated against major international currencies in the first half of 2003 (Chart 4) as the external value of the rand continued to recover, thus reflecting the policy link between the Pula and the rand through the multi-currency basket. In the first half of 2003, the Pula appreciated by 8.5 percent against the SDR, 11.3 percent against the US dollar and 2.2 percent against the euro. It depreciated by 3.8 percent against the rand in the same period. Despite the significant changes in bilateral exchange rates of the Pula against international currencies (mainly the US dollar), the nominal effective exchange rate remained relatively stable in line with Botswana's fixed exchange rate policy, appreciating by only 0.3 percent during the first half of the year.*



(f) *Real Exchange Rates*

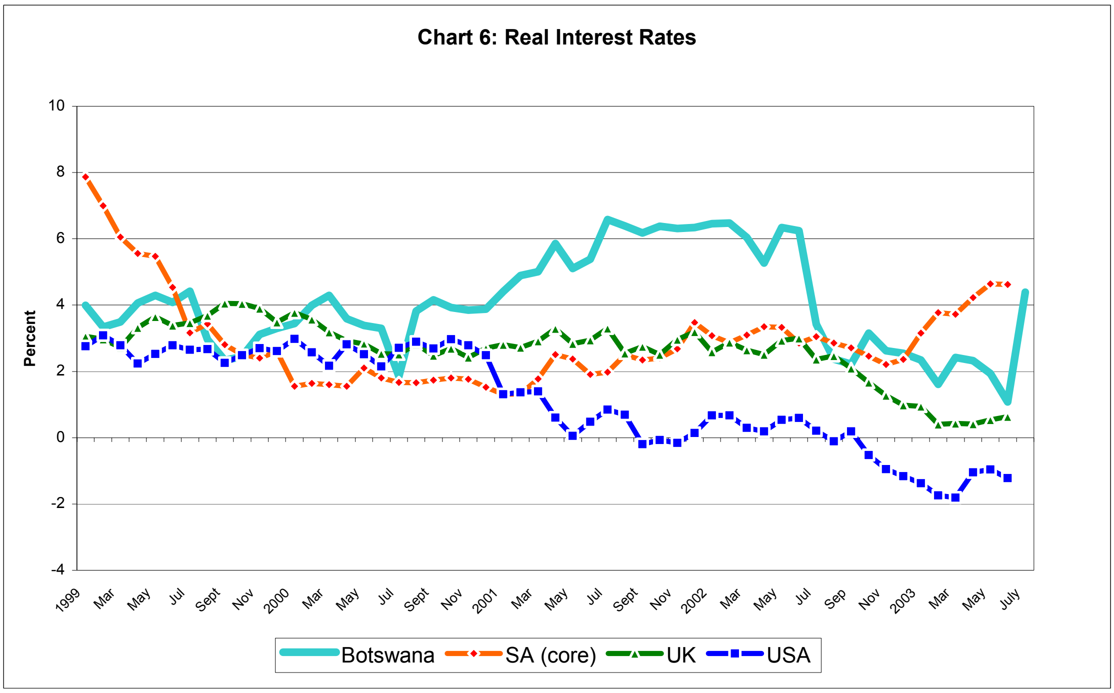
2.9 *In the five months to May 2003, international competitiveness was eroded as the real effective exchange rate of the Pula appreciated by 2.9 percent, following the 2.8 percent appreciation in 2002 (Chart 5). The appreciation of the real exchange rate reflected higher inflation in Botswana than in trading partner countries which, in turn, was due largely to the introduction of VAT. However, in view of the fact that the real exchange rate measure is based on the consumer price index, which includes the effect of VAT, there is a possibility that the erosion of international competitiveness of Botswana producers may be exaggerated since VAT is not relevant in such international comparisons.*



3. *Implementation of Monetary Policy in the first half of 2003*

3.1 *In order to ensure that inflation slows towards the Bank's desired range of 4 – 6 percent by the end of the year, monetary policy remained restrictive in the first half of 2003, following the increase in the Bank Rate by 1 percent (in two equal parts) at the end of last year. Correspondingly, other interest rates remained stable during the first half of the year. The commercial banks' prime lending rate remained constant at 16.75 percent, while the three-month Bank of Botswana Certificate (BoBCs) rate stabilised at around 14 percent.*

3.2 *In response to rising inflation, real interest rates maintained a downward trend in the first half of the year. The real 3-month BoBC rate fell from 2.5 percent in December 2002 to 1.1 percent in June 2003, which was below comparable rates in South Africa, but above those in the UK and USA (Chart 6). In July, however, the real BoBC interest rate rose to 4.4 percent as inflation fell.*



4. *Outlook for Inflation in the rest of 2003*

(a) *External Factors*

4.1 *Global inflation fell modestly in the first half of the year due mainly to the decline in energy prices as well as the weak global economic activity; it is forecast at 2.7 percent for the whole of 2003. Growth is expected to accelerate in the second half of the year as the effects of expansionary fiscal and monetary policies adopted in most of the major economies are felt.*

4.2 Inflation in South Africa is declining and forecast to be within the South African Reserve Bank's (SARB) 3 – 6 percent target range by the end of the year. Economic activity has slowed, with real GDP growing at an annual rate of 2.5 percent in the first quarter of 2003, compared to 3 percent the previous quarter. The slowdown in economic activity is attributable mainly to a decline in the volume of exports resulting from the appreciation of the rand and the subdued global economy. Interest rates are expected to decline in the second half of the year and this should support a revival of economic activity.

(b) Domestic Factors

4.3 Growth rates of key domestic demand indicators (commercial bank credit and government spending) have been falling since late last year. Credit growth fell to 13.9 percent at the end of June 2003 (within the desired 12 – 14 percent range), and government spending growth was only marginally above the desired levels in the first quarter. If the current trends in credit and government spending are sustained, domestic inflationary pressures should ease during the remainder of the year.

4.4 Consistent with expectations, inflation decreased in July 2003 to 9.2 percent from the June level of 12.8 percent, as the VAT-induced increase in inflation dropped out of the inflation calculation. The reduction in fuel prices at the beginning of July also contributed to the reduction in inflation.

4.5 However, there is still uncertainty about the response of the Government to the report on the structure of public sector salaries, and on the extent of supplementary budget approvals. Large supplementary budgets and/or unsustainable salary increases that are not matched by reductions elsewhere in the government budget could lead to a rise in domestic expenditure and a corresponding increase in inflationary pressures.

4.6 The 4 – 6 percent inflation objective set out in the 2003 MPS was intended to help regain some of the competitiveness lost during 2002 and to maintain low inflation expectations. The current trends and forecasts of growth rates of credit and government spending suggest that the inflation objective for the year remains appropriate and, with a substantial slowing of monthly price increases in the second half of the year, headline inflation should end the year closer to the upper end of the desired range.

5. Summary and Conclusions

5.1 Inflation rose sharply following the introduction of VAT in July 2002, and has continued to rise through the first half of 2003. Besides VAT, prices have recently been driven by the rising cost of certain foodstuffs, motor vehicles, airfares and, lately, the increase in BHC rentals.

5.2 *Domestic inflation is, however, expected to decline in the second half of the year for a number of reasons. The effects of VAT dropped out of the inflation calculation in July 2003. In addition, the reduction in fuel prices in July is also expected to contribute to low inflationary pressures in the second half of 2003. An additional significant factor is that domestic demand pressures, as indicated by the rates of growth in both credit and government expenditure, are slowing and, if sustained, will contribute to an easing in inflation pressures in the economy.*

5.3 *External factors are also supportive of a more favourable inflation outlook. Global inflation is expected to remain stable and low during the remainder of the year. In South Africa, inflation is expected to decline further, with an increased prospect of reaching the 3 – 6 percent target during the year.*

5.4 *Therefore, for the remaining part of the year, the Bank will adhere to the current inflation objective of 4 – 6 percent, and to the 12 – 14 percent growth in private sector credit as it is consistent with the inflation goal. The Bank will continue to monitor the relevant indicators and will take appropriate policy action, as necessary, in light of both financial and price developments during the rest of the year.*