

BANK OF BOTSWANA
RECENT ECONOMIC AND POLICY DEVELOPMENTS

Presented to BOCCIM Members in Francistown

By

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I wish to welcome you to this annual get-together of senior Bank of Botswana executives and the members of the Francistown business community, as well as others who have an interest in the work of the Bank. It is an important event in the Bank's calendar because of the opportunity it provides to exchange views on recent economic and financial developments and their implications for the Bank's policies with stakeholders such as yourselves.

Of course, this is not the only way we interact with stakeholders. Each year we publish the Monetary Policy Statement and a mid-year review of it, and these provide a comprehensive analysis of the economic and financial situation as it relates to inflation in Botswana, both on a backward and forward looking basis, and an assessment of the risks and challenges for the Bank in pursuing its policy objectives.

Again each year we publish the Bank's Annual Report and one on banking supervision that contain an assessment of economic, financial and banking

developments during the year in question, an explanation of the Bank's policy response to these developments, and a write-up on a chosen "theme topic", particularly in the Bank's Annual Report. The theme topic is meant to focus on a particular issue of relevance to the Bank, the economy, and we hope, to you the Bank's stakeholders. Last year, the issue explored was productivity and its importance to sustainable economic growth. This year's Annual Report will no doubt have a theme topic which will receive intensive analysis.

As you may be aware, the Bank's usual approach at meetings such as this one has been presentations by my senior colleagues of the contents of the Annual Reports, with an update of developments since the Reports were published. While we will continue with this general approach, we have decided that it is more beneficial to focus on more recent developments. This is in recognition of the fact that, by this time of the year, the previous year's position has been overtaken by events. This is particularly the case this year, as you will appreciate as I go through my prepared statement.

Another change to what we have been doing at this gathering is that I will deliver the brief this time.

I will begin by reviewing recent economic and financial developments, globally, regionally and domestically, highlighting their importance for inflation in Botswana. I will then describe and explain the Bank's policy response to these developments before highlighting an assessment of the outlook for inflation and its potential policy implications. I will conclude by a

short brief on other areas of the Bank's responsibilities, such as banking supervision.

As far as the global economy is concerned, its performance continued to improve in the first half of 2005, underpinned by strong growth in productivity and demand in the USA which, in turn, has stimulated investment and export growth in Japan and emerging Asian economies, particularly China. In contrast, growth in the euro area has lagged behind. This productivity induced robust output growth has meant that global inflation has continued to be moderate, despite the continuing rise in fuel prices occasioned by fears of geopolitical tensions and destructive weather conditions.

In the circumstances, average inflation in Botswana's trading partner countries - South Africa and the SDR countries (comprising the USA, UK, the euro area and Japan) - was also moderate and, as a result, it remained considerably lower than in Botswana. While there has been some upward pressure on inflation in recent times because of higher oil prices (including in South Africa), it is generally expected to be contained and, in some cases, to decline as oil prices stabilise.

Here at home, inflation went down between February and April this year as the effect of the February 2004 devaluation fell out of the inflation calculation. The decrease in inflation, to 6.2 percent in April, reflected low domestic demand pressures and the benign influence of external price increases. There were, as well, no significant increases in administered prices early in the year other than for fuel, the price of which was raised by

an average of 5 percent at the beginning of May in response to rising international oil prices. However, following the 12 percent devaluation of the Pula at the end of May, and further increases in the price of fuel and other administered prices, inflation has risen substantially to a level of 10 percent in September.

The principal source of the more recent rise in inflation has been the increase in the cost of imports, which has nearly doubled since the end of last year, to 13.8 percent in September. Inflation for non-tradeables (services such as bus fares, catering and hospitality) has, on the other hand, fallen from just over 10 percent in December last year to just over 5 percent in September this year, suggesting limited second-round effects on prices from the devaluation and fuel price increases.

The year-on-year growth in commercial bank credit remains moderate and largely consistent with the Bank's inflation objective and, at 9.5 percent in August, it is below the lower end of the Bank's desired credit growth range of 11 – 14 percent. Growth in credit has been restrained by the absence in the government's budget of a salary increase for civil servants and the Bank's relatively restrictive monetary policy. Growth in government spending has also been generally supportive of monetary policy. Recent indicators suggest that expenditure growth may have been somewhat lower than the 9.9 percent indicated in this year's Budget Speech.

With regard to exchange rate developments, and as you are aware, the Pula was devalued on May 30, 2005 by 12 percent, and a crawling band exchange rate regime introduced. The Pula continues to be pegged to a

basket of currencies, consisting of the South African rand and the International Monetary Fund's Special Drawing Right (SDR), which is a composite currency comprising the US dollar, British pound, Japanese yen and the euro. The new exchange rate regime has introduced a different approach to the Pula exchange rate management. The Pula will now be adjusted in small continuous steps, rather than in large discrete ones as was the case in the past. It is a forward-looking crawl, the rate of which is based on the differential between the Bank's inflation objective and the forecast average inflation for trading partner countries. Furthermore, to introduce more flexibility to the exchange rate, the band around the central parity was widened, from ± 0.125 percent to ± 0.50 percent, and 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. This exchange rate arrangement will allow for a more active monetary policy and will, over time, reinforce its effectiveness in achieving the inflation objective.

While monetary policy focuses on attaining low and stable inflation to achieve real exchange rate stability in the longer term, in the short-term, domestic inflation may deviate significantly from trading partner average inflation. This would result in a depreciation or appreciation of the real exchange rate, thus necessitating an adjustment of the nominal Pula exchange rate to correct for a real exchange rate misalignment.

The devaluation of the Pula in May and the new arrangement for the exchange rate has meant that the nominal effective exchange rate, which had been stable since the February 2004 devaluation, had depreciated by

over 13 percent by the end of last month. This is a combination of the 12 percent devaluation and the subsequent downward crawl, as inflation in Botswana remains higher than the average inflation of trading partner countries. Furthermore, and of interest to many of you, in the five months following the devaluation, the Pula has appreciated by 2.7 percent against the SDR, thus offsetting some of the 12 percent devaluation, while it has depreciated by 3.6 percent against the rand.

Monetary policy over the past 6 – 8 months has been influenced by these developments. The positive inflation outlook earlier this year allowed the Bank to lower the Bank Rate in April by 25 basis points to 14 percent, prompting the commercial banks to do likewise with market interest rates. The outlook for inflation changed considerably, however, following the devaluation and the recent large increases in administered prices, forcing the Bank to increase the Bank Rate by 25 basis points on August 5, and again this week, on Wednesday. A further signal that the Bank would resist any excessive rise in inflation resulting from the devaluation and administered price increases, was given when the Bank's inflation target range of 3 – 6 percent was increased in August by 1 percent to a range of 4 - 7 percent.

In doing so, it was recognised that given the estimated inflationary effect of the devaluation, it would be unrealistic to expect the targeted level of inflation to be achieved in the short-term. However, it is important for monetary policy to maintain expectations of low and stable inflation and to signal the Bank's commitment to an eventual decline in inflation in the

medium-term, hence the only partial accommodation of the expected rise in inflation in the target range of 4 – 7 percent.

Adjusting upwards the inflation objective range does not mean that the Bank loosened monetary policy, as overall inflation in the short run will only be allowed to rise by around 2 percent without meeting increased policy resistance. This was done to prevent the rise in inflation from feeding through to the prices of domestic resources and domestically produced goods and services. In order for Botswana's resources and the users of those resources to become more competitive, the prices of those resources must not rise as much as the extent of the devaluation. To the extent that other domestic policies that affect aggregate demand remain prudent, particularly fiscal policy, less will be required from monetary policy to ensure this objective is met.

Looking ahead, world economic performance is expected to remain robust, despite concerns about the effect of rising oil prices on output expansion, with world GDP expected to grow to a level above the average of the past ten years. Global inflation is expected to decline from just below 4 percent in 2004 and 2005 to nearly 3 percent in 2006, largely in response to more stable oil prices as well as the pre-emptive monetary policy tightening undertaken in some major economies.

In South Africa, growth is expected to continue at around 4 percent, and inflation to rise somewhat, although expectations are that it will remain within the South African Reserve Bank's target of 3 – 6 percent. In the circumstances, external inflationary pressures on inflation in Botswana are

expected to remain benign, except for the effect of the devaluation of the Pula.

Domestic demand pressures, as indicated by the projected growth rates of government expenditure and credit to the private sector, are expected to continue to be moderate in the short to medium-term. In the light of recent increases in the Bank Rate, monetary policy remains relatively restrictive and, to the extent that the moderate annual rate of increase in budgeted government spending is realised, demand pressures should continue to be restrained going forward. Moreover, domestic demand will be further dampened by the negative income effect of the devaluation and market competition.

There are, nevertheless, significant upside risks to the potential improvement in the underlying situation, arising mainly from the continuing uncertainty with respect to oil prices and other administered prices. A more expansionary fiscal policy, which could include a possible compensating wage increase to civil servants, is also a risk to inflation. However, the Government has indicated that its fiscal stance will remain prudent and generally in line with existing budget estimates.

Although inflationary pressures due to domestic demand factors seem contained, and the influence of foreign inflation is benign, domestic inflation can be expected to remain at relatively high levels and above the inflation objective for the rest of the year and into 2006, mainly due to the impact of the devaluation of the Pula on import prices and increases in administered

prices. Once the full effect of the devaluation has passed, and taking into account the recently announced increases in fuel prices and telecommunications tariffs, inflation should stabilise in the coming months.

What does all this mean for monetary policy in the short-term? In an environment in which inflation is rising and there is a danger of inflation expectations leading to a continuous rise in inflation, it is important for the Bank to be vigilant. As stipulated in the Bank of Botswana Act, the primary mandate of the Bank is to ensure monetary and financial stability. This is interpreted to mean the maintenance of sustainable low inflation, as the means by which the Bank contributes to economic growth. It is considered that low inflation, among others, encourages financial savings and reduces uncertainty in investment decisions, thus contributing towards productive investment by both local entrepreneurs and foreign investors. In addition, achieving low inflation close to the average of that of Botswana's trading partner countries supports a more stable real effective exchange rate, which can boost competitiveness of Botswana's export industry; it also obviates the need for a rapid downward adjustment of the nominal exchange rate.

To achieve the inflation objective, the Bank has a forward-looking monetary policy framework which has, as its main elements, the use of interest rates to influence demand conditions in the economy. Interest rates work through their effect on credit growth and then on demand conditions in the economy. Interest rates also affect not only domestic demand through its influence on credit growth, it also signals the desired level of inflation in the

economy and, to the extent that the monetary policy framework is credible, they will have a moderating influence on inflation expectations.

It is recognised that there are those who believe there are less costly ways of fighting inflation. For example, there is a suggestion that an increase in interest rates has little or no effect on credit demand; instead, the Bank should be lowering interest rates. This argument ignores the fact that apart from the cost effect, an increase in interest rates can also lead to income constraints, thus reducing the availability of funds to purchase goods and services, the consumption of which could be postponed, and hence reducing overall domestic demand. The converse is, of course, also true; reducing interest rates stimulates demand.

A second criticism of the Bank's policy is that higher interest rates than those prevailing in South Africa, for example, is undesirable. Admittedly, a comparison of the level of interest rates and inflation prevalent in Botswana and South Africa is relevant, but we must ensure that we are comparing similar if not identical economic indicators. The current lower level of interest rates in South Africa is commensurate with the South African Reserve Bank's success in containing inflation through an earlier period of tight monetary policy and a marked appreciation of the rand in 2003 and 2004. In Botswana, while demand pressures have generally been restrained due to the impact of restrictive monetary policy on credit growth and the moderate rate of growth in government expenditure, inflation has remained at relatively high levels due to the devaluation of the Pula and the substantial increase in many administered prices. In the circumstances, the Bank has had to signal its desire, to achieve lower inflation through

higher interest rates, in order to support the broader national objective of sustained economic growth.

Overall, it is important in the context of a transparent and, to some extent, interactive policy formulation process, for the Bank to receive feedback on its operations. The Bank hopes that such feedback and appraisal of its policy framework and actions recognises that monetary policy is only one of several policies used to facilitate productivity and sustainable economic growth, and has a specific role of ensuring monetary stability. Any attempt to use this single instrument to achieve multiple objectives would inevitably result in conflicting priorities.

I have delved at length about the Bank's monetary policy and the context in which it is being conducted. But as you know, the Bank is more than only interest rates and exchange rates. I wish, therefore, to share with you, only briefly, some aspects of the Bank's work, particularly those which may have bearing on yourselves as members of the public and/or business community with vested interests in the welfare of the banking sector. These are the Bank's banking regulatory and supervisory as well as currency issuer responsibilities.

At last year's economic briefing, you brought to the Bank's attention a number of legitimate concerns regarding operational procedures and policies of commercial banks especially the cost and quality of banking services. It was also pointed out that the policy of excessive centralised decision making in credit assessment and approval slowed down customer service and reduced operational efficiency. Other issues of legitimate

concern included the need for banks to introduce flexibility in their range of products and corresponding pricing structures in order to broaden customer choice. Similarly, you pointed out that the implementation of the “Know-Your-Customer” policy needed to cater for those that may not have physical addresses.

The Bank has consistently engaged the commercial banks on these and other related issues, the result of which has been some discernible positive results in a number of areas, particularly on the pricing structures. Improvements in some aspects of customer service have also been observed and customer needs are increasingly being catered for. It is the Bank’s expectation that today’s interaction will lead to more improved results.

You may wish to take comfort in the fact that this year’s Banking Week theme - “Customer Education: Informed, Wiser and More Disciplined Banking” - stressed the importance of customer education with emphasis on their rights and obligations. It is for this reason that the Bank encourages you to continue to take an interest in the manner in which the banking sector conducts its business, and take full advantage of the Banking Adjudicator’s Office in dealing with your daily concerns.

With regard to currency, and as you know, the Bank has the sole responsibility for the procurement and issue of Pula notes and coin. In this respect, the Bank continually reviews and upgrades the security features of different denominations of Pula banknotes, in particular the higher

denominations that are more susceptible to counterfeiting, as a way of ensuring continued public confidence in the national currency.

The Bank will continue to improve the security features of all banknotes and, as usual, you will be advised in advance of any changes, no matter how subtle.

There is not enough time to address all of the many different challenges that the Bank and its stakeholders continuously face. I hope you do take the time, when you can, to read the Bank's publications such as the Annual Report and Monetary Policy Statement, so that you can make enlightened contributions to the work of the Bank as and when the opportunity presents itself.

I end my remarks by thanking you for joining us at this economic briefing and for your attention and patience. My colleagues and I are eager to hear and respond to your usual constructive questions, comments, observations and even criticisms.