

BANK OF BOTSWANA

PRESS RELEASE

Mid-Year Review of 2004 Monetary Policy Statement

In February 2004, the Bank of Botswana released the Monetary Policy Statement (MPS), outlining several objectives for the year. The purpose of the mid-year review of the MPS, which we are releasing today, is to present a progress report on the extent to which the monetary policy objectives, outlined in February 2004, have been achieved half way through the year, to examine the prospects for the financial and economic outturn for the remainder of the year and to evaluate the need or otherwise for a change in the current monetary policy stance.

As you will recall, the 2004 MPS set an inflation objective of 4 – 7 percent for 2004. In the first six months of the year, inflation has largely remained within this range. Following a sharp decline in the second half of 2003, headline inflation rose in the first half of 2004, from 6.4 percent in December 2003 to a peak of 7.4 percent in May, before declining to 6.7 percent in June. Inflation rose marginally to 6.8 percent in July 2004. However, domestic demand pressures were moderate, with annual growth in credit to the private sector falling within the desired range and the rate of growth of government spending slowing down.

The upward trend in inflation arose primarily from the 7.5 percent devaluation of the Pula in February 2004, but the increase in inflation was relatively small compared to the size of the devaluation. This is attributed to a number of factors: first, the fact that inflation was already falling prior to the devaluation, as a result of price developments in South Africa and moderating domestic demand pressures and, second, the likelihood that domestic competitive pressures acted to moderate the impact of the devaluation on prices. Overall, the devaluation is estimated to have added 2 - 3 percentage points to inflation in the first half of 2004.

Global inflation eased to 2 percent in the first half of 2004, from 2.4 percent in the second half of 2003, despite the rise in oil prices. However, average inflation in Botswana's trading partner countries rose from 3.5 percent in December 2003 to 4.6 percent in June 2004, reflecting, in the main, higher inflation in South Africa.

In view of the fact that the main objective of monetary policy is to control demand-induced inflation, the Bank focuses on the growth rate of commercial bank credit, which contributes to domestic demand pressures and can be influenced by monetary policy. Consequently, monetary policy remained restrictive in the first half of the year, with the Bank Rate maintained at 14.25 percent, in order to restrain credit growth in the light of the anticipated increase in public service salaries, and to sustain expectations of low inflation following the devaluation of the Pula and an increase in some administered prices. In the event, annual credit growth remained low, falling to 10.1 percent in June 2004, below the bottom end of the range of 12 – 15 percent that the Bank considers to be consistent with the inflation objective of 4 – 7 percent for the year.

Looking ahead, there is a risk that inflation will rise moderately during the second half of 2004, due mainly to external price pressures and increases in domestic administered prices. While global inflation remains low, there is an upside risk due to the rise in economic activity and the effect of the recent sharp increase in international oil prices. Inflation is forecast to increase in many of the major economies in the short to medium term and, in response, global interest rates are being raised to mitigate inflationary pressures.

Domestically, demand pressures, as indicated by the growth rates of government expenditure and credit to the private sector, continue to be moderate and should remain consistent with the inflation objective during the remaining part of 2004. The main threat to domestic inflation is administered prices, in

particular the second round effects of the fuel price increase of June, and the recent (August) increase in public transport fares, which is expected to add approximately 0.5 percent to inflation.

While domestic demand developments are generally supportive of a positive inflation outlook, there are risks, particularly relating to increases in administered prices, high oil prices and rising inflation internationally, which could cause inflation to temporarily move above the desired range in the second half of the year.

The 2004 inflation objective of 4 – 7 percent was chosen to allow for a gradual adjustment to the devaluation of the Pula, but at the same time ensuring that the gain in competitiveness which the devaluation was intended to achieve would not be eroded by higher inflation. In the light of developments in the first half of the year, and anticipated developments in trading partner countries inflation, the Bank considers that this inflation objective (4 – 7 percent) remains appropriate for the remainder of the year.

The task for the current policy stance is to sustain the moderate growth rates for credit and, therefore, the aggregate demand consistent with the inflation objective, without compromising economic growth. There is also the need to maintain expectations of low inflation given the threat posed by the increase in administered prices and global inflation. The Bank will continue to monitor the relevant indicators and take appropriate policy action, as necessary, in light of both financial and price developments during the rest of 2004.

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