MID-TERM REVIEW OF 2005 MONETARY POLICY STATEMENT

1. Introduction

1.1 The mid-term review of the Monetary Policy Statement (MPS) is intended to achieve three main objectives. First, to review progress in the first six months of the year in attaining the objectives of monetary policy as outlined in February 2005; second, to examine the financial and economic outlook for the remainder of the year and, in this regard, evaluate any need for a change in the policy stance; and third, to inform stakeholders of the key issues that are likely to be relevant to policy formulation in the second half of the year so as to support the formation of expectations, particularly with respect to inflation.

1.2 In setting the inflation objective of 3 – 6 percent for 2005, the Bank considered, among others, inflation in trading partner countries, which was forecast to be lower in 2005 compared to 2004, implying a need to lower the 2004 inflation objective of 4 – 7 percent in order to meet the related objective of a stable real effective exchange rate. Moreover, it was considered that the new lower objective was achievable in the context of a relatively restrictive monetary policy and subdued demand pressures and the expected falling away of the impact of the February devaluation from the inflation calculation in the first half of the year.

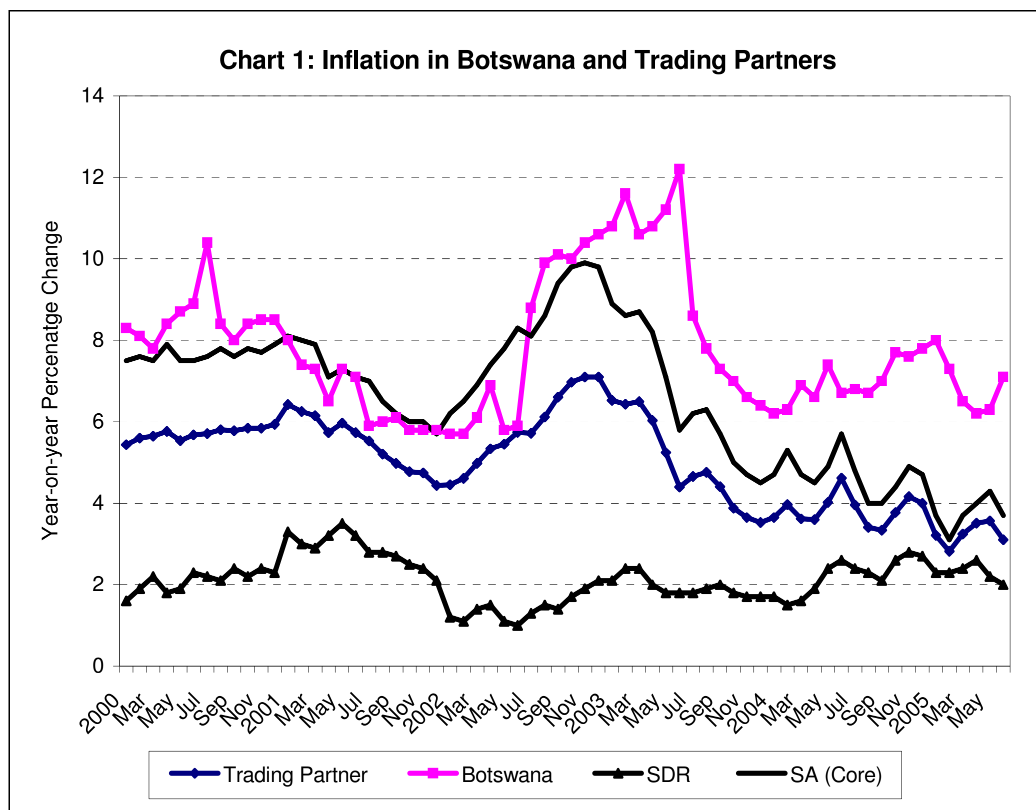
1.3 As the primary objective of monetary policy is to control inflation through changes in domestic demand, the Bank focuses on commercial bank credit as an intermediate target, the growth of which contributes importantly to domestic demand pressures and can be influenced by monetary policy. Furthermore, while it has no direct influence on fiscal policy, the Bank also monitors the level of Government spending, focusing on the rate of growth that is considered non-inflationary, as it is a major component of consumption and investment expenditure. Monetary policy must also be responsive to and influence the formation of expectations with respect to inflation, particularly in the context of discrete and transitory shocks such as a devaluation. To this end, the Bank stands ready to act to moderate the inflationary effects of Government fiscal measures and expectations, should that be necessary.

2. Economic and Financial Developments during the first half of 2005

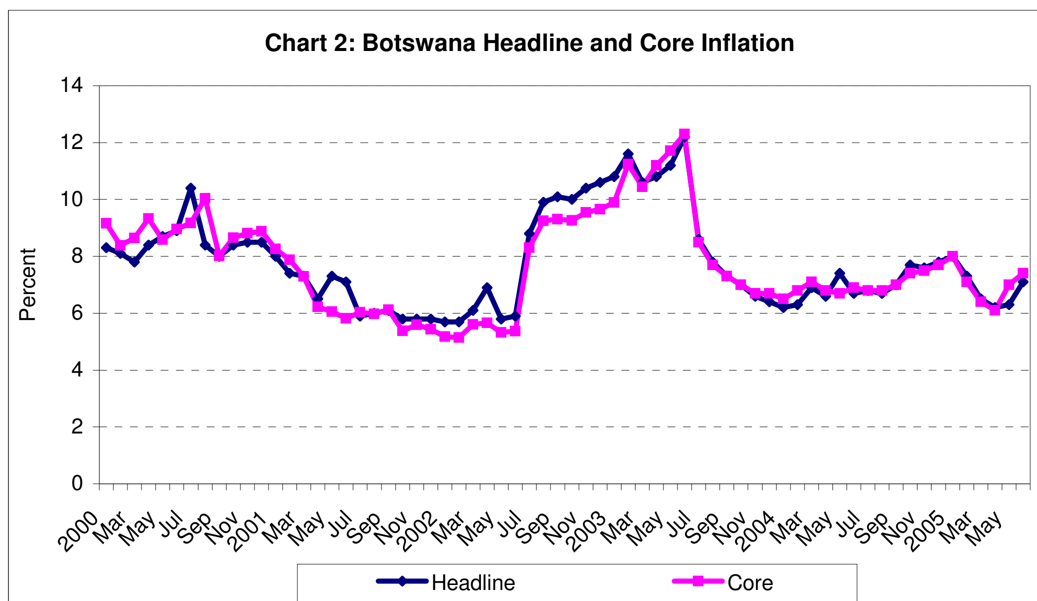
(a) International Developments

2.1 Global economic performance improved in the first half of 2005, underpinned by strong growth in productivity and demand in the USA, stimulating investment and export growth in Japan and emerging Asian economies, particularly China. In contrast, euro area growth continued to lag behind. Global inflation eased slightly to 3.6 percent in 2005 from 3.7 percent in the second half of 2004 despite the rise

in fuel prices occasioned by fears of geopolitical tensions causing production and supply disruptions. *Average inflation in Botswana's trading partner countries*[1] *also fell during the first half of 2005, to 3.1 percent in June 2005 from 4 percent in December 2004 (Chart 1), reflecting the increasingly restrictive monetary policy in the USA and the UK, and the continuing subdued demand conditions in Europe and, to a lesser extent, Japan. South African core inflation decreased from 4.7 percent at the end of 2004 to 3.7 percent in June, while average inflation for the SDR countries fell from 2.7 percent in December 2004 to 2.0 percent in June 2005.*



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



(b) Domestic Developments

2.2 *Domestic inflation fell between February and April 2005 as the effect of the February 2004 devaluation fell from the inflation calculation. The decrease in headline inflation, from 7.8 percent in December 2004 to 6.2 percent in April was attributable to low domestic demand pressures and the benign influence of external price increases, while there were no increases in administered prices other than for fuel. These prices were raised by an average of 5 percent at the beginning of May as international oil prices remained high, which resulted in a marginal rise in inflation to 6.3 percent. Core inflation*[2] *decreased to 7 percent in May, from 7.7 percent at the end of 2004.*

2.3 *Following the 12 percent devaluation of the Pula at the end of May, inflation rose sharply to 7.1 percent in June as prices began to be adjusted upwards in response to the increase in Pula denominated import costs. Core inflation also rose to 7.4 percent, indicative of the generalised price increase after the exchange rate adjustment.*

2.4 *Prior to the devaluation, prices of imported tradeables had risen by 8.2 percent annually in May 2005 from 7.6 percent in December 2004, largely reflecting the average 5 percent increase in fuel prices in May***,** *while inflation for domestic tradeables had declined from 5.6 percent at the end of 2004 to 3.7 percent in May 2005. For non-tradeables, the annual increase in prices had fallen substantially from 10.2 percent at the end of 2004 to 5.6 percent in May. However, in June 2005, the year-on-year rise in the cost of imported tradeables increased to 8.7*

[2] The Bank uses the trimmed mean approach to measure core inflation. This approach removes the most extreme price changes, regardless of their source and direction.

percent and domestic tradeables inflation rose to 5.6 percent both partly due to the effect of the devaluation. For non-tradeables, the annual rate of price increase rose marginally to 5.9 percent.

2.5 *The year-on-year increase in commercial bank credit rose to 12.6 percent in June 2005 from 11.8 percent in December 2004*[3] *and 9.8 percent in June the previous year, and was within the Bank's range of 10 – 13 percent that is consistent with the 3 – 6 percent inflation objective. On average, credit grew by 10.4 percent in the first six months of 2005 compared to 10.3 percent in the second half of 2004. Generally, growth in credit was restrained by the absence of a salary adjustment for civil servants in 2005 and maintenance of a relatively restrictive monetary policy in the first half of the year.*

2.6 *Overall, government spending has generally supported monetary policy in an environment in which inflation was above the objective range. In the revised budget for the fiscal year 2004/05 (April-March) total recurrent and development expenditure was projected to rise by 10.2 percent, moderately higher than 8.9 percent of 2003/04 but within the range considered by the Bank to be consistent with its 3 - 6 percent inflation objective. However, more recent indicators based on provisional data (shown in chart 3) suggest that actual spending growth may have been somewhat lower than budgeted. In turn this could imply more rapid rates of spending growth in 2005/06.*

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[3] The commercial bank credit growth figures have been adjusted to include lending by Investec Bank, following the merger of the merchant bank with Stanbic Bank.

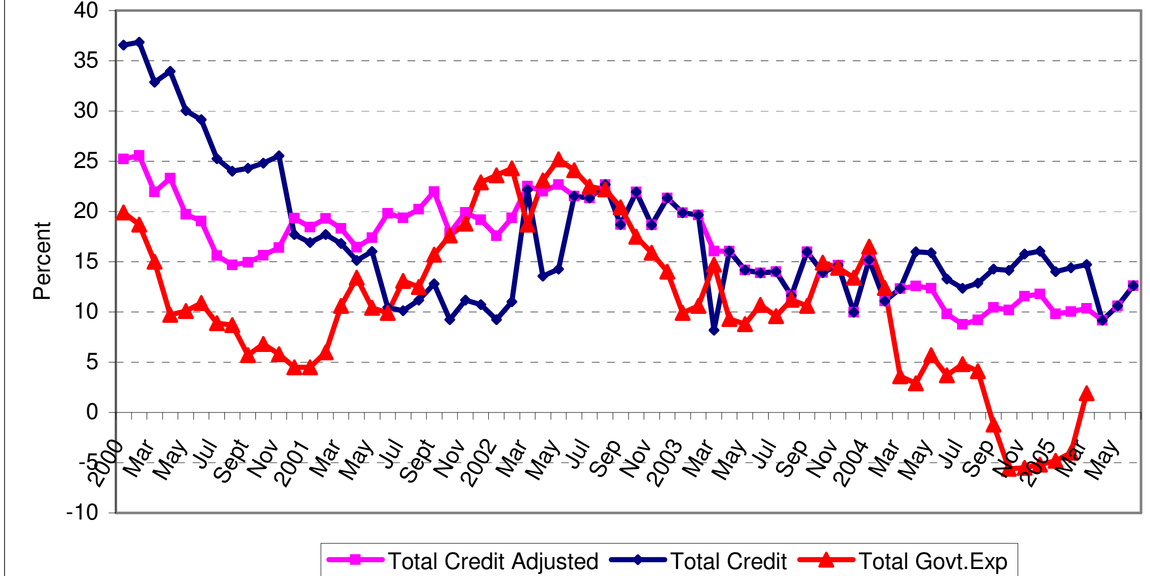


Chart 3: Annual Growth Rates of Credit and Government Spending
(January 2000 - June 2004)
40
35
30
25
20
15
10
5
0
-5
-10
Percent
2000
Mar
May
Jul
Sept
Nov
2001
Mar
May
Jul
Sept
Nov
2002
Mar
May
Jul
Sep
Nov
2003
Mar
May
Jul
Sep
Nov
2004
Mar
May
Jul
Sep
Nov
2005
Mar
May
Total Credit Adjusted
Total Credit
Total Govt.Exp

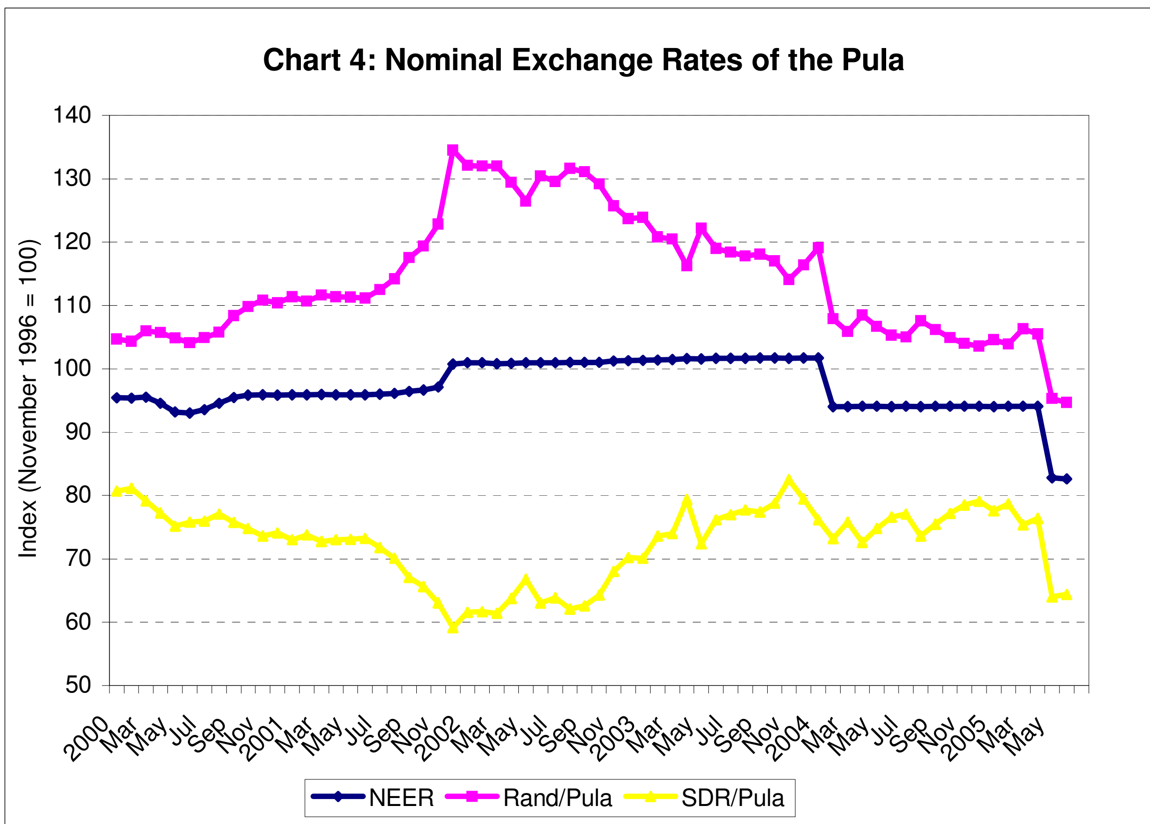


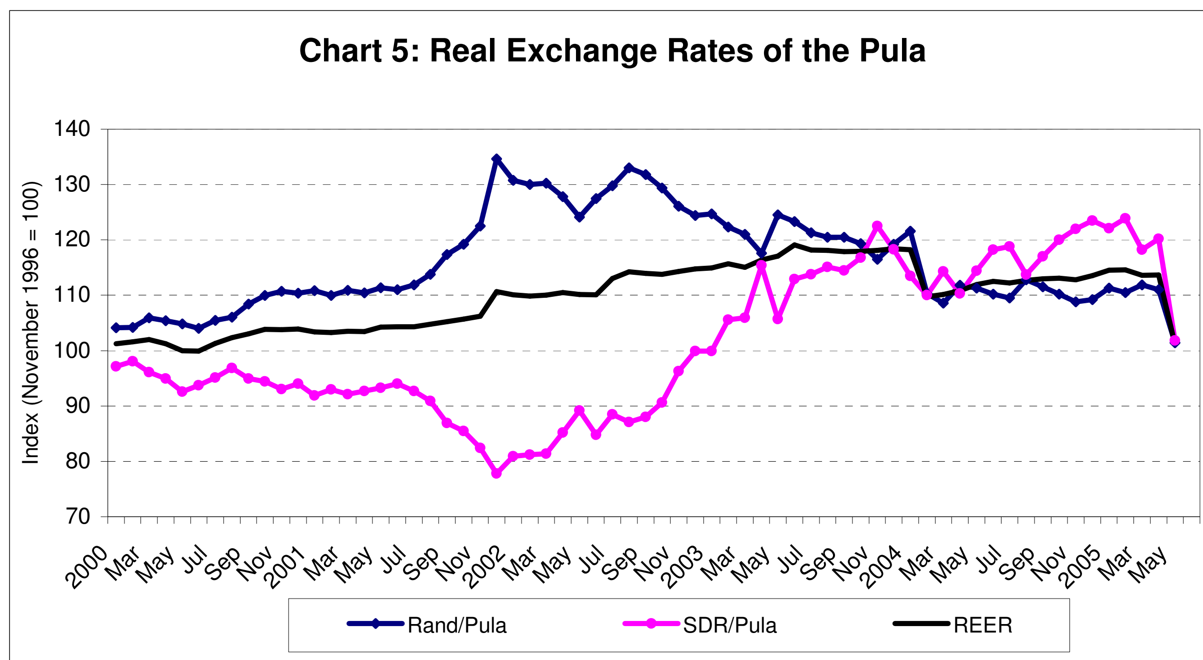
Chart 4: Nominal Exchange Rates of the Pula
140
130
120
110
100
90
80
70
60
50
Index (November 1996 = 100)
2000
Mar
May
Jul
Sep
Nov
2001
Mar
May
Jul
Sep
Nov
2002
Mar
May
Jul
Sep
Nov
2003
Mar
May
Jul
Sep
Nov
2004
Mar
May
Jul
Sep
Nov
2005
Mar
May
NEER
Rand/Pula
SDR/Pula

(c) Exchange Rate Developments

2.7 *The Pula was devalued by 12 percent and a crawling band exchange rate regime introduced on May 30, 2005. In the new arrangement, the Pula continues to be pegged to a basket of currencies consisting of the South African rand and the IMF Special Drawing Right (SDR), a composite currency comprising the US dollar, British pound, Japanese yen and the euro. The crawling band mechanism means that the exchange rate will now be adjusted in small continuous steps, rather than in large discrete ones, through a forward-looking crawl with the rate of crawl based on the differential between the Bank's inflation objective and the forecast inflation for trading partner countries. Moreover, the existing symmetrical intervention band around the central parity was widened from +/-0.125 percent to +/- 0.5 percent to encourage the development of the domestic foreign exchange market and a more market-determined exchange rate responsive to changes in economic fundamentals. This exchange rate arrangement allows for a more active monetary policy and reinforces its effectiveness in achieving the inflation objective. While monetary policy focuses on attaining low and stable inflation to achieve, in the longer term, real exchange rate stability, it is possible that, in the short-term, domestic inflation may deviate significantly from trading partner inflation, resulting in the depreciation or appreciation of the real exchange rate, thus necessitating a nominal adjustment to correct for the real exchange rate misalignment. In the context of the new regime, this will be achieved by continuous small adjustments in the nominal rate rather than by the previous large infrequent adjustments.*

2.8 *The nominal effective exchange rate, which had been stable since the February 2004 devaluation of the Pula, had depreciated by 12 percent by the end of June 2005, following the devaluation of the same magnitude at the end of May. Bilaterally, in the five months prior to the devaluation, the Pula had depreciated by 7.1 percent vis-à-vis the SDR, mainly reflecting a 10.9 percent weakening against the US dollar, while it appreciated by 4 percent against the rand. As a result of the May 2005 devaluation, the Pula weakened in the first half of 2005 by 18.6 percent against the SDR and by 9.5 percent against the rand. Year-on-year to the end of June, the Pula weakened by 13.9 percent and 11.2 percent against the SDR and the rand, respectively.*

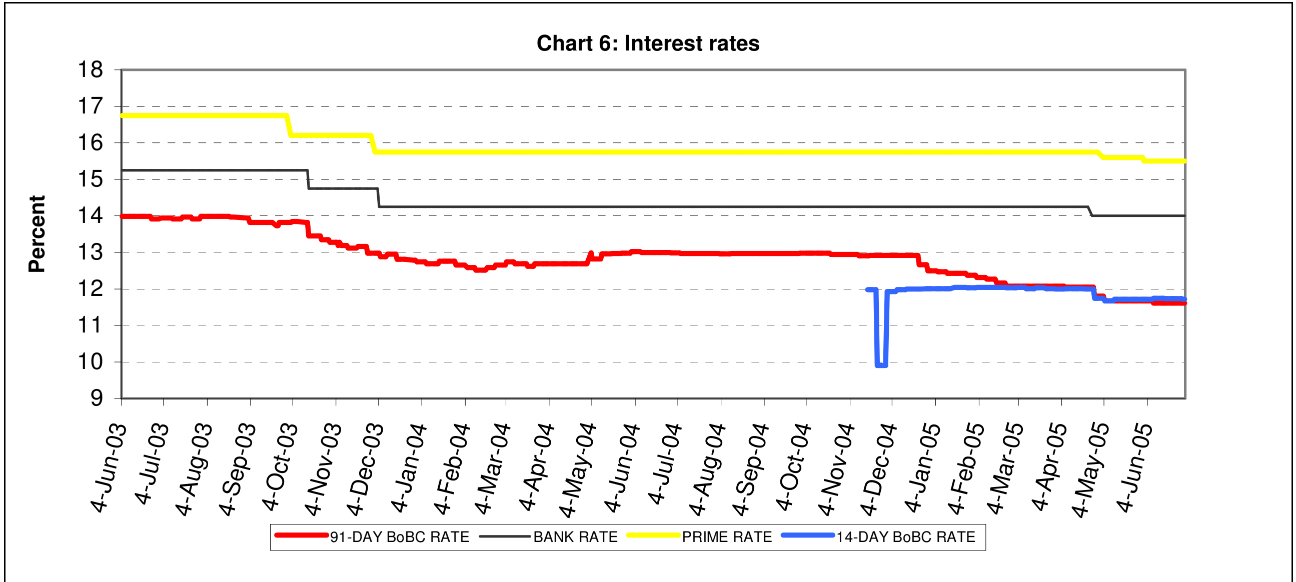
2.9 *In the context of the fixed nominal effective exchange rate, the continuing higher rate of inflation in Botswana compared to trading partner inflation meant that the Pula's real effective exchange rate (REER) was generally appreciating in the period prior to the devaluation at the end of May. In the fifteen months since the previous devaluation in February 2004, this appreciation of the REER had amounted to 3.6 percent, mostly against the rand (see Chart 5).*



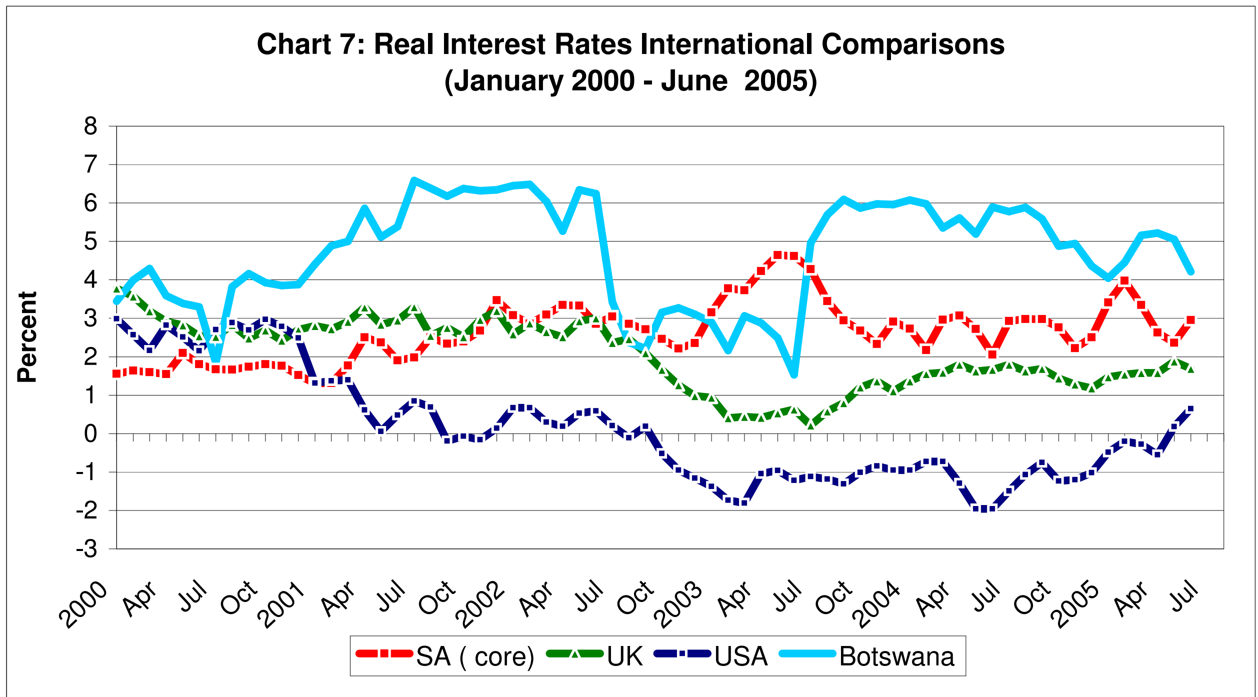
3. Monetary Policy Developments

3.1 Inflationary pressures were largely contained in the first half of the year, mainly due to the relatively restrictive monetary policy and Government spending restraint, particularly the absence of a general wage increase award for public servants. There were as well no increases in administered prices except for fuel, which was necessitated by persistently high and rising international oil prices. External inflationary pressures were also low in the context of a fall in commodity prices (other than the price of oil), productivity improvements, competition in the goods market, and pre-emptive monetary policy tightening in the US and UK.

3.2 Given the then positive inflation outlook, the Bank Rate was reduced by 25 basis points to 14 percent in April 2005. Correspondingly, commercial banks reduced their prime lending rates by a similar amount to 15.5 percent. Deposit rates were also lowered with the average 88-day deposit rate falling to 8.8 percent in June 2005 from 9.1 percent in December 2004. Other short-term interest rates also declined. The three-month BoBC rate fell from 12.5 percent in December last year to 11.61 percent in June 2005, while the 14-day BoBC rate moved down from 12.01 percent to 11.72 percent over the same period. However, even prior to the Bank Rate cut, there had been a decrease in the BoBC yield, due to the reduced volume of the 91-day paper following the introduction of the 14-day paper, while the yield curve remained inverted, indicative of expectations of a decline in inflation and interest rates in the short to medium term. The 2-year government bond (BW001) matured at the end of May and was not rolled over. This resulted in a rise in BoBC holdings to absorb the ensuing excess liquidity.



Note: Effective May 1, 2004, the three months BoBC rate is the weighted average of successful bid yields at auction, while prior to that it was of the average of the offer and the bid price; hence, it was called '3 Months BoBC Mid rate'. The change caused the reported BoBC rate to increase by 30 basis points (0,3 percent).



3.3 The real 3-month BoBC rate (i.e., the nominal rate adjusted for inflation) fluctuated between 4 percent and 5.5 percent (Chart 7) during the first six months of 2005, increasing as inflation fell for most of the first half of the year, but was lower at 4.2 percent at the end of June 2005 compared to the 4.4 percent rate at the end of December 2004 as inflation rose following the devaluation. In an

environment of relatively high nominal rates, real interest rates in Botswana continue to be higher than comparable rates in South Africa[4]*, the UK and USA.*

4. Inflation Outlook

(a) External Factors

4.1 Despite concerns about the effect of rising oil prices on output expansion, world economic performance is expected to stabilise around current levels of between 4 – 4.5 percent. Global inflation is expected to decline marginally to 3.6 percent in 2005, from 3.7 percent in 2004 and is forecast to fall further to near 3 percent in 2006. However, there continues to be an upside risk due to continuing robust economic activity and the possibility of further increases in oil prices. The forecast decline in inflation mainly reflects the effect of pre-emptive monetary policy undertaken in some of the major economies to contain inflationary pressures. It is, nevertheless, considered that, globally, monetary policy remains accommodative of output expansion.

4.2 In South Africa, an increase in real wages, interest rate cuts and accelerating government expenditure are expected to contribute to higher output growth of over 4 percent in 2005, compared to 3.7 percent in 2004. Meanwhile, inflation remains low, largely in response to effective monetary policy and fiscal discipline, as well as appreciation of the rand in the recent past. Although there are upside risks to inflation due to the expected rise in demand and weakening of the rand, as well as persistently high international oil prices, CPIX inflation[5] *is forecast to remain within the South African Reserve Bank's target range of 3 – 6 percent in the short to medium term. Overall, except for the effect of the devaluation of the Pula, external inflationary pressures on inflation in Botswana are expected to remain benign.*

(b) Domestic Factors

4.3 Domestic demand pressures, as indicated by the projected growth rates of Government expenditure and credit to the private sector, continue to be moderate and are expected to remain so for the rest of 2005. While the Bank Rate was cut by 25 basis points in April, 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.

4.4 Nevertheless, there are significant upside risks to this relatively positive underlying situation, excluding the devaluation effects, for inflation. These

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[4] The South African real rate is deflated by core inflation.

[5] The South African Reserve Bank's target measure of inflation which excludes mortgage interest from the headline measure of inflation.

involve mainly the continuing uncertainty with respect to oil prices and other administered prices. A more expansionary fiscal policy as a result of the devaluation, including possible compensating wage increases, is also a risk to inflation. The Government has, however, indicated that its fiscal stance will remain prudent and generally in line with existing Budget estimates. Inflationary pressures may also be generated by expectations of further large discrete devaluations of the Pula. Given that the new crawling band exchange rate regime clearly removes the need for such adjustments in the exchange rate, pressures on inflation from this source should not persist once the new regime is fully operational.

4.5 Overall, despite restrained domestic demand pressures and the benign foreign inflation, domestic inflation is expected to rise considerably in the second half of the year due to the impact of the devaluation of the Pula on import prices. Consequently, inflation can be expected to move above the upper end of the current inflation objective range of 3 – 6 percent during the remainder of 2005 and into 2006. Given the importance of import prices in the Consumer Price Index (CPI), the direct impact of the 12 percent devaluation on inflation could be as much as 5 - 6 percentage points over the next 9 - 12 months. The actual rise in inflation is likely to be somewhat less than this, however, given the underlying moderate domestic demand conditions and benign external inflation pressures. In the circumstances, and in light of the experience following last year's 7.5 percent devaluation, the Bank expects the May 2005 devaluation to add between 2 – 4 percentage points to inflation in the months through to early 2006.

5. Monetary Policy Stance

5.1 At the beginning of the year, and in the context of the Bank's monetary policy framework, the inflation objective of 3 – 6 percent was set in relation to ensuring a continuation of the downward trend in inflation that was beginning to emerge. At the lower end, it related directly to expected inflation rates in trading partner countries, which, if achieved, was expected to contribute to a more stable real effective exchange rate. The wider range and the upper end of the inflation objective reflected the desire to bring inflation down toward the longer-term objective of low and stable inflation on a steady path and at a measured pace. Half way through the year, forecast trading partner inflation has been revised downwards, thus implying a need to focus on achieving an inflation rate in the lower end of the objective range in order to meet the related objective of a stable real effective exchange rate. The expected inflationary effect of the devaluation, however, makes achieving this level of inflation unrealistic in the short-term.

5.2 It is, however, considered important to maintain expectations of low and stable inflation and signal the Bank's commitment to an eventual decline in inflation in the medium-term. As noted earlier, the Bank expects that the 12 percent devaluation could add 2 - 4 percentage points to inflation in the coming months. To anchor expectations of inflation and to ensure it will be contained, the

objective range is set at 4 - 7 percent for the remainder of the year. Accordingly, monetary policy will respond to any significant rise in inflation above the upper end of the revised objective. This recognises the transitory nature of the anticipated contribution of the impact of the devaluation to inflation and the importance of preempting any continuous increase in inflation arising from expectations. An upward revision to the objective range obviates the need for a sharp tightening of monetary policy to achieve the current objective, which in the current circumstances would be costly in terms of lower output growth and consequent rise in unemployment.

5.3 In the context of the new exchange rate regime, a rise in inflation more than is currently expected would necessitate a much steeper crawl and this would raise the risk of a further increase in inflation beyond what is expected. Given that the impact of the devaluation will be transitory and that there is a need to restrain any inflationary pressures that might arise due to an increase in demand or expectations, the range for the desired rate of credit growth is also increased, albeit by less than the maximum expected increase in inflation resulting from the devaluation. For the remainder of this year, therefore, the new credit monitoring range is 11 - 14 percent, an increase of one percentage point from the current range of 10 - 13 percent. It is desirable that the annual increase in Government expenditure remains moderate.

5.4 Adjusting upward the inflation objective range for the second half of 2005 does not mean the Bank is loosening 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 is done to prevent the rise in inflation from feeding through to the prices of domestic resources and domestically produced goods and services. Hence, 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 devaluation. To the extent that other domestic policies that affect aggregate demand, particularly fiscal policy, remain prudent, less will be required from monetary policy.

5.5 The Bank's monetary policy stance is also related to and complements the new crawling band exchange rate regime. The previous fixed exchange rate peg did not provide for a mechanism, apart from a discrete devaluation, for a nominal adjustment of the exchange rate in the event that the decline in domestic inflation was not sufficient to ensure real exchange rate stability. The new crawling band regime allows for a more flexible approach to changes in the exchange rate in that the wider band around the crawling peg permits adjustment of the exchange rate to take care of both competitiveness and inflation concerns, as circumstances require.

5.6 The rate of crawl is to be determined on a forward-looking basis, so that it moves in line with the difference between the domestic inflation objective and forecast foreign inflation. The fact that domestic inflation will remain higher than that of

Botswana's trading partners for at least the coming year implies that the initial crawl will be downward, i.e., the Pula will be devalued against the currency basket in small amounts on a daily basis that will in total equal the expected inflation differential over a 12-month period.

5.7 *The existence of the small continuous rate of crawl and the manner of its determination is intended to anchor inflation expectations around the Bank's inflation objective and mitigate concerns about possible large discrete devaluations in the future. It should be noted that the crawl is symmetrical and that the downward crawl would be reversed in the event Botswana inflation falls below trading partner forecast inflation. The Bank remains committed to the long-term objective of low and stable inflation in the context of a more flexible exchange rate arrangement. A more measured rate of crawl over time, rather than large discrete devaluations, facilitates monetary policy effectiveness towards achieving low and stable inflation over the medium to long-term as the nominal exchange rate adjusts gradually to meet the objective of real effective exchange rate stability.*

6. Summary and Conclusions

6.1 *Inflation generally fell for most of the first half of 2005 indicative of restrained demand pressures and low external inflation. Going forward, inflation is expected to rise and remain above the 3 – 6 percent objective set at the beginning of the year largely due to the effect of the May 2005 devaluation. It is, however, expected that domestic competitive pressures and reduced demand due to the devaluation, as well as low foreign inflation will have a moderating effect on inflationary pressures. Overall, it is anticipated that the rise in inflation due to the devaluation will be limited to 2 – 4 percentage points and that it will be transitory and one-off, spread over several months. Significant upside risks to this potential outcome exist, however, from further oil price increases, administered prices, and an expansionary fiscal policy.*

6.2 *For the remainder of the year the Bank will, in consideration of the impact of the May 2005 devaluation, aim to achieve an inflation objective of 4 – 7 percent through an appropriate monetary policy stance supported by continuance of moderate growth in Government expenditure and restraint in raising administered prices. In this regard, the Bank will continue to monitor the relevant indicators and will take appropriate policy action, as may be necessary, in light of developments with respect to demand pressures and the rate of price increases for the rest of 2005, including those that may be due to upward adjustment of administered prices and any second round effects of these transitory shocks.*