2002 MONETARY POLICY STATEMENT

by

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[Distinguished Guests, Ladies and Gentlemen etc.]

Introduction

For several years now the Bank has used its annual Monetary Policy Statements to report on inflation and monetary policy developments in the previous year, and to provide an assessment of the prospects for inflation for the year ahead. More recently, these annual Statements have been supplemented by mid-year reviews, highlighting progress made in the first half of the year in meeting monetary policy objectives, and updating forecasts and analysis relating to the remaining six months. The 2002 Monetary Policy Statement builds on this approach.

As in the past, the Statement reviews recent developments in inflation and monetary policy, and presents the Bank's analysis and policy position for 2002. For the first time, the Statement includes the Bank's explicit annual objectives for inflation and credit growth; it also provides more detailed information on the framework used by the Bank in the formulation of monetary policy.

The Bank's Monetary Policy Framework and Objectives

Let me begin by briefly describing the Bank's policy objectives and the framework used to achieve them. While much of what I will say will be familiar to many of you, I believe it is helpful in understanding the reasons for policy actions if we are clear, not only on what policy is trying to achieve, but also on how policy goes about achieving its objectives.

There are three main elements to the Bank's current approach to monetary policy. The first and most important element is the underlying objective of monetary policy, which is the achievement of sustainable low inflation. It is generally accepted that the control of inflation is the means by which monetary policy contributes, along with other Government policies, to the ultimate national goal of rising incomes and living standards.

The second element of the framework is the Bank's support of the more immediate national objective of export competitiveness and economic diversification. Controlling inflation helps Botswana generally to maintain external competitiveness. In pursuing its longer-term objective of sustainable low inflation, the Bank seeks specifically to achieve an annual rate of inflation that will, at a minimum, maintain relative stability in the real exchange rate and avoid the need for a devaluation of the Pula.

The third element of the Bank's framework is the need for monetary policy to balance the achievement of low and sustainable inflation with the needs of the real economy. To this end, the Bank takes into account the needs of both savers and investors by keeping interest rates at a level which provides a positive real return to savers, but ensuring that private sector borrowing to finance viable investment projects is not discouraged. In this regard, the Bank seeks generally to maintain real interest rates at levels that are comparable to those prevailing in international capital markets. Any deviation from these rates will be primarily due to differing inflationary or deflationary pressures in Botswana relative to comparator countries.

In assessing the extent of these pressures and the need for a change in interest rates, the Bank focuses on the rate of growth of credit to the private sector as the main intermediate target. The rate of growth of Government spending is also factored in, given that such a large proportion of domestic demand is derived from expenditure on public consumption and investment. I hasten to add that the continuing large size of Government in the economy underscores the importance of fiscal and monetary policies sharing the burden of achieving and maintaining low inflation.

While credit growth and Government spending are the main indicators of domestic demand growth monitored by the Bank, other data used to assess the appropriate path for interest rates include measures of external demand and cost pressures, as well as indicators of domestic costs, such as wage growth, productivity and capacity growth.

There is one further observation I wish to make on the Bank's policy framework. It concerns the Pula exchange rate policy. As many of you are aware, there has been a lot of comment recently about whether the current policy of pegging the Pula to a basket of currencies comprising the South African rand and the IMF's Special Drawing Right (SDR) is still appropriate. The Bank's position is that the current exchange rate policy is appropriate; it is the best arrangement in the current circumstances. The policy aims at balancing competing needs and interests, based on broad trade and capital flow considerations. Of course, the Bank recognizes that there is no one exchange rate arrangement that is perfect for all countries all of the time; circumstances change and so should policies, in response. I can assure you that the Bank continually reviews all policy frameworks, including the exchange rate regime, to ensure its overall effectiveness in fulfilling the Bank's mandate and its relevance to broad national economic goals.

Developments in Inflation in 2001

I would now like to speak to inflationary developments in 2001. It was within the policy framework I described earlier that last year's Monetary Policy Statement specified the Bank's objective of achieving a reduction in inflation from the increased levels of 2000. While inflation abroad was rising, and credit growth in Botswana suggested that domestic demand pressures remained excessive, it was expected that international inflation pressures would begin to ease, and that monetary policy measures already in place in Botswana would contribute towards reduced inflationary pressures arising from domestic demand.

In the event, inflation in Botswana eased in 2001, reaching, as you know, 5.8 percent in December 2001 compared to 8.5 percent at the end of 2000. In fact for the last three months of 2001, inflation stabilised at the lowest level since February 1985, when it was 5.4 percent. The reduction in inflation was a combined effect of a declining inflation globally, as well as lower international oil prices, all of which led to a sharp drop in imported inflation.

On the domestic front, demand pressures on inflation were comparable with those in 2000, as indicated by the growth rates of credit to the private sector and Government spending. Although credit growth averaged 13.2 percent in 2001, compared to 28.4 percent in 2000, the figure understates the underlying trend rate because of the impact of the extension and subsequent early repayment of loans by some large borrowers, using offshore funds. When these loans are excluded, credit growth did not slow down significantly in 2001; it remained between 15 percent and 20 percent.

Another source of rapid expansion in domestic expenditure was the annual growth rate of Government spending, which averaged 11 percent during 2001, similar to the average for 2000. However, towards the end of the year the growth rate picked up sharply, indicating that there are emerging demand and inflationary pressures arising from the 2001/2002 Government budget.

Although the national accounts for 2000/2001 show that the economy grew by 9.1 percent, marginally higher than the 8.1 percent recorded during the 1999/2000 national accounts year, the higher economic growth was largely the result of a very large increase in mining output, which in turn reflected the impact of the completion of the Orapa 2000 expansion project. When the effect of growth in mining and that of Government expansion are excluded, the rest of the economy grew by only 3.0 percent, compared to 6.2 percent in 1999/2000, indicating a considerable economic slowdown in the non-mining sector. In other words, available goods and services grew at a slower rate in 2000/2001, than in the previous year when mining and Government are excluded. The GDP figures suggest, therefore, that aggregate demand may be growing more slowly than the picture presented by the credit growth and Government spending indicators.

With regard to exchange rates, the main development during 2001 was the rapid depreciation of the South African rand against major international currencies. As a result of the link to the rand through the currency basket, the Pula also depreciated against major international currencies, losing 20 percent of its value against the SDR during the year. However, the Pula appreciated markedly against the South African rand, gaining 22 percent during 2001. Overall, in nominal effective terms, the Pula was relatively stable for most of the year. However, volatility in bilateral exchange rates, particularly towards the end of 2001, caused the Pula to appreciate in effective terms, for technical reasons, and, by the end of the year, the nominal effective exchange rate of the Pula was 5.1 percent higher than at the end of 2000. This may have contributed to the slowdown in the rate of inflation on imported commodities which became evident during the year, particularly towards the end of 2001.

Even though the rate of inflation fell in 2001, it was still above the weighted average of the inflation rates of Botswana's major trading partners. This factor, combined with the appreciation of the nominal effective exchange rate, led to a 6.8 percent appreciation of the real effective exchange rate; to this extent, the Pula lost international competitiveness.

Monetary Policy Implementation During 2001

As indicated earlier, the Bank's implementation of monetary policy in 2001 was aimed at responding to these developments. Accordingly, the 2001 Statement stressed the need to maintain the downward momentum in credit expansion by staying the course with respect to interest rates until such time that there was clear evidence that inflationary pressures had abated. Although there was a temporary rise in inflation in the middle of the year, due to a rental increase by the Botswana Housing Corporation, inflation declined in 2001. Nevertheless, monetary policy remained restrictive, for several reasons. The reduction in inflation was largely due to imported inflation, and it was the Bank's view that the more modest gains on domestic inflation had not been sustained for a long enough time. There were also concerns about continuing high demand pressures. For example, the growth rates of both credit and Government expenditure were at undesirably high levels by the end of the year, and there were potential inflationary consequences arising from the increase in disposable incomes due to the mid-year public sector wage and salary increases. These developments added to the risk of a reversal of the decline in inflation, especially if monetary policy had been eased.

As a result, there was little change in nominal interest rates. However, since inflation was declining, the actual effect of the policy stance was that Botswana's real interest rates rose during 2001. As at the end of the year, the real interest rate for the short term paper, the three-month Bank of Botswana Certificate, was 6.1 percent, compared to 3.9 percent at the end of 2000. The increase in real interest rates contrasted with the downward trend in major economies, which resulted from easing of monetary policy.

Outlook for Inflation in 2002

With respect to the Bank's perspective and outlook for 2002, a number of factors have been taken into account in the assessment of inflationary pressures this year. Global economic growth is expected to remain relatively weak and inflationary pressures subdued. It also appears that the risks to this generally benign international outlook lie with oil prices and inflation in South Africa. As we all know, oil prices have been considerably lower than earlier in the year since the attacks of September 11 in the United States. However, the pledge by OPEC members to curtail their production, and indications that many non-OPEC members will do the same, bring about prospects of an increase in oil prices in 2002.

With respect to inflation in South Africa, which is the most important external influence on Botswana inflation, the recent sharp depreciation of the rand against major international currencies could reverse the downward trend in that country's inflation. While the full extent of the pass-through of the depreciation to domestic prices is uncertain, at the moment core inflation in South Africa is forecast to rise to around 6.8 percent by the middle of the year and to average 7.2 percent for the whole of 2002. In contrast, inflation in major industrial countries is forecast to average 1.2 percent in 2002, similar to the 2001 experience. If the nominal effective exchange rate of the Pula remains stable, this will imply that imported inflation in Botswana in 2002 is likely to be slightly higher, on average, than it was in 2001.

The factors that are expected to affect overall domestic expenditure during this year are, at the moment, mixed. Export demand is likely to remain subdued due to low rates of global economic growth and, possibly, the impact of the nominal appreciation of the Pula in 2001, which can cause some switching from domestic demand to import demand. The possible switch from domestic to imported supplies may ease the pressure from credit growth on domestic supply. Nevertheless, as at the end of 2001, underlying credit growth remains undesirably high and Government expenditure growth began to accelerate in 2001 compared to 2000. The 2002 Budget Speech indicates that this trend will continue, with Government spending projected to rise sharply by 27 percent in the 2002/2003 fiscal year, compared with the 2001/2002 fiscal year. While there is a strong possibility that Government spending will not rise as much as planned, due to implementation constraints, there will still be a significant rise in domestic expenditure.

In addition to expenditure and supply considerations, adjustment in administered prices, such as fuel prices, transport costs and Botswana Housing Corporation rentals, will have an impact on inflation. The introduction of Value Added Tax (VAT) in July 2002 is also likely to cause a one-off increase in the price level.

Monetary Policy Stance in 2002

What does all this mean for monetary policy in 2002? On the basis of the Bank's assessment of currently available forecasts of inflation for this year in South Africa and the SDR countries (USA, Europe, UK and Japan), inflation in Botswana needs to be at a level that would achieve general stability in the real effective exchange rate. If this objective is to be achieved, it is imperative that inflation should be kept within a range of 4 - 6 percent during 2002.

This inflation objective, which the Bank will seek to achieve, is expressed as a range to reflect the possibilities of different outcomes in the current forecast for inflation in South Africa and the SDR countries. If inflation in these countries meets or exceeds the average of the forecasts, then inflation in Botswana will need to stay within the upper part of the range. Similarly, if inflation outcomes in these countries throughout 2002 are tending to improve on the average expected rate, the Bank will aim to ensure that inflation in Botswana falls within the lower part of the range. As has been the case before, the Bank will, half way through 2002, review and evaluate whether this inflation objective needs adjusting in light of inflation trends elsewhere.

It is also the Bank's view that, in order to attain the desired inflation range of 4 – 6 percent, the growth rate of private credit that is considered to be compatible with achieving this inflation outcome should be in the range of 12.5 – 14.5 percent. The continuing relevance of this range will also be reassessed in the mid-year review in light of fiscal developments.

Summary and Conclusions

In conclusion, I would like to reiterate that inflation in 2001 was in the desired direction compared to the previous year. This trend was greatly facilitated by developments in trading partner countries, including South Africa, which led to the easing of imported inflation. Expectations for 2002 are that non-inflationary growth should resume in major industrial economies - excepting perhaps Japan - by the second half of the year, due in large part to the aggressive easing of monetary policy by central banks in these countries during 2001.

Even though industrial countries are expected to resume economic growth sooner, there appears to be very little risk of a rise in inflation in these countries, although there is uncertainty regarding oil prices and inflation in South Africa. The main threat to inflation domestically is demand pressures arising from the projected sharp increase in Government spending in the 2002/2003 fiscal year. To the extent that the Government under-spends, the threat will be more manageable and the need for tightening monetary policy further will be less urgent. If inflation in trading partner countries increases, the Bank will need to ensure that the resulting pressure on domestic costs do not lead to a generalised increase in inflation in Botswana.

Therefore, the task for monetary policy during 2002 will be to ensure that inflation is kept within the 4 - 6 percent range. To achieve this, there is need for continued restraint in the growth of domestic expenditure, especially the portion that is financed by domestic credit. The need to contain credit growth will be particularly acute in light of the announced increase in public expenditure.

Honourable Ministers, distinguished Ladies and Gentlemen, these are the challenges we face. The benefits of successful containment of inflation have significance that transcends the interests of all economic groups. The benefits will accrue to all of us as individuals and businesses since the maintenance of macroeconomic stability is an integral part of the Government's economic policy. I hope I can count on your cooperation in pursuit of the lofty and ideal objective of reigning in inflation.

I thank you for your attention.