2009 MONETARY POLICY STATEMENT

by

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Governor

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Honourable Speaker of National Assembly
Honourable Minister of Finance & Development Planning & your Colleagues in Cabinet & Parliament
Your Excellencies, Members of the Diplomatic Corps
Chairman of the House of Chiefs
PSP, Senior Government Officials & Heads of Parastatal Organisations
Members of the Board of the Bank of Botswana
Members of the Banking Fraternity, representatives of the wider financial sector & Captains of Industry
Distinguished Ladies and Gentlemen
Good evening.

By way of *introduction*, I welcome you to this ceremony, marking the launching of the Monetary Policy Statement for 2009. As you know, the Monetary Policy Statement is a means through which the Bank informs the nation and other stakeholders about the monetary policy framework and its implementation. In doing so, we seek to reinforce the credibility of the Bank's determination to anchor

expectations of low, predictable and sustainable level of inflation. This is the primary objective of the Bank, and rightly so. I hasten to stress that the focus on controlling inflation should, in no way, be taken to imply that other considerations concerning the health of the domestic economy are ignored.

As always, on this occasion the Bank reviews economic and inflation developments in the past year, and explains the actions taken in response to those developments. This includes an assessment of the success or otherwise of meeting the medium-term inflation objective. The Statement also updates the economic and financial outlook, and proposes a possible strategy for addressing the challenges in the period ahead.

You may recall that, last year, the Bank introduced important modifications to the policy strategy, which reinforced the medium-term as the time horizon in which to meet the inflation objective. This approach is based on more rigorous inflation forecasting.

Before I delve into the main business of this evening, I feel it is always useful, even for those who regularly attend this

event, to highlight the other *core functions of the Bank*, in addition to keeping inflation in check.

The other major function of the Bank is to provide financial and economic advice to the Government, which is done through regular consultations with the Ministry of Finance and Development Planning. It is, of course, appropriate that, in most cases, this advice is provided on a privileged and confidential basis.

The supervision and regulation of the banking sector, which is essential for maintaining a sound, stable and efficient financial system, is another critical function of the Bank. Prudential supervision and monitoring of licensed financial institutions ensure that they comply with the regulations designed to protect the interests of customers and the financial system for the benefit of the economy as a whole.

The Bank is also responsible for designing, printing and distributing currency to the wider economy to facilitate payment for transactions, usage as a unit of account and store of value. Related to this function is ensuring that Botswana has a secure and efficient payments and settlement system, which is critical for the stability of the

financial sector and its ability to promote economic activity. Moreover, as Banker to the Government and commercial banks, the Bank of Botswana serves as the lender of last resort.

Yet another important function of the Bank is operating a foreign exchange market with commercial banks, so that residents can engage in transactions with the rest of the world.

The Bank also manages the exchange rate in order to ensure international competitiveness of domestic exports, by stabilising the real effective exchange rate through a crawl of the nominal effective exchange rate. When domestic inflation is higher than the forecast inflation of trading partner countries, a downward crawl is implemented; the reverse is true when the inflation objective is lower than forecast trading partner countries' inflation.

Last but not least, the Bank is responsible for investing a portfolio of the country's foreign exchange reserves, which is a major part of the country's wealth. This involves buying and selling a wide range of investment instruments in

international financial and capital markets, while strictly observing acceptable risk parameters.

In carrying out all these functions, which contribute to the sound economic and financial well-being of the country, the Bank is committed to maintaining the highest level of corporate governance and professional excellence.

Before I share with you a summary of this year's Monetary Policy Statement, I wish to make some observations on the rapidly unfolding *global financial and economic crisis*. This is a matter of national importance and, inevitably, it forms a backdrop for the review of monetary policy; it also has an impact on the policy strategy in the period ahead.

The Bank has been monitoring the deteriorating outlook for the world economy since the emergence of the crisis in late 2007, and we have willingly shared our thoughts at regular economic briefings and in the Bank's publications; please be assured that this process will continue in the course of this year.

Crises have been, and will continue to be a feature of the global economy. Almost 250 years ago, Adam Smith, who is known as the father of capitalism, wrote perceptively about

the dangers of speculative excess. Indeed in a system that encourages dynamic development, imbalances requiring correction are inevitable; but the severity of the current economic slowdown is the worst since the Great Depression of the 1930s, in part because of globalisation of national economies. That is why the International Labour Organisation has warned that some 50 million jobs worldwide could be lost; that is why all countries including Botswana are affected; and that is why the responses have to be coordinated, to some extent.

It is now widely acknowledged that the current crisis can be attributed to three major factors. First, the sharp rise in commodity prices, especially oil and food, was always likely to put a brake on economic expansion. Second, the uneven global growth resulted in unsustainable huge deficits in some countries and corresponding chronic surpluses in others. Therefore, painful adjustment was inevitable. Third, risk management in financial sectors of major economies was lax, so much so that some of the most respected names in banking accumulated large volumes of non-performing assets.

These factors were also substantially interlinked. The virtual disregard for prudential lending by the financial sector led to the emergence of unsustainable macroeconomic imbalances and rising commodity prices. Central Banks, too, were on the wrong side of the action, as their formulation and implementation of monetary policy paid insufficient attention to the risks of over-valuation of assets, particularly in the housing market(s).

In the event, the consequences have been traumatic, especially since September 2008, when the global banking system risked collapse starting with the erstwhile US-headquartered Lehman Brothers. Although this has been averted through unprecedented action by governments and central banks, the subsequent curtailment of lending has aggravated economic slowdown. The seriousness of the "credit crunch" is such that the International Monetary Fund has revised its economic growth forecast for 2009 repeatedly, from 3.8 percent to only 0.5 percent. The economies of advanced countries are forecast to shrink by an average of 2 percent this year. For sub-Saharan Africa, the 2009 outlook has fallen from 6.8 percent to 3.5 percent, and the volume of global trade is expected to fall for the first time since the early 1980s.

To address the problems, many central banks have reduced interest rates to historic levels, while governments have undertaken unprecedented spending and financial support of private sector entities. It is not surprising, therefore, that the G20 and similar groupings are considering proposals to coordinate revisions to financial sector regulation.

So far, efforts to stabilise the banking system have not resulted in a resumption of bank lending; for this reason, it is feared that economic recovery may take longer, possibly way into 2010. There is also concern that countries will increasingly resort to protectionist trade policies, a trend that would be self-defeating since no economy can resolve its problems in isolation.

Fortunately, commercial banks in Botswana are not yet impaired by the impact of the "credit crunch" that is afflicting other countries. Bank deposits far exceed loans; and banks have generally avoided accumulating unmanageable risk. In this connection, it is worth mentioning that Batswana should learn from the mistakes of over-borrowing, the dire consequences of which have hit households elsewhere in the world very hard. Nevertheless,

the Bank of Botswana is monitoring possible situations of exposure to offshore parent financial institutions on an ongoing basis.

While the domestic financial sector is, to some extent untroubled, international diamond markets have deteriorated rapidly and unexpectedly. As highlighted by the Honourable Minister of Finance and Development Planning in this year's budget speech, this development has adversely affected government revenue.

As at the end of January 2009, which is three months after diamond exports were seriously curtailed, the foreign exchange reserves amounted to 69.7 billion Pula (provisionally), which is a 19 percent growth from the December 2007 level of 58.5 billion Pula. When the effect of the Pula depreciation is excluded, the reserves fell by 6.4 percent in terms of Special Drawing Right (SDR) and by approximately 12 percent in US dollar terms. The decrease in reserves was due to the fall in equity market prices, a slowdown in diamond export receipts and payments for government and other transactions.

The pressure on the reserves is expected to continue during 2009, although at the level equivalent to 27 months of import cover, they should remain relatively adequate. I believe it should take little persuasion to acknowledge that managing the country's reserves prudently has served the country well, given the current severe financial and capital markets difficulties.

I now turn to the core business of this evening's event: the Bank's *monetary policy framework and strategy* for 2009.

As I said earlier, last year's modifications to the framework focused on the medium-term, a period considered appropriate for monetary policy to take effect and anchor the inflation objective, based on rigorous inflation forecasting that is now taking root at the Bank.

For the sake of emphasis, the Bank's monetary policy objective is to achieve a sustainable, low and predictable level of inflation within a range of 3 – 6 percent over the medium term. Maintaining inflation within this range supports broader national objectives of sustainable economic growth and development, through promoting savings mobilisation and productive investment, as well as

sustaining international competitiveness of domestic producers.

However, the process of keeping inflation in check is not in one direction; for instance, sustained periods of low or rapidly falling inflation could indicate subdued economic activity; in which case, monetary policy would need to be eased to stimulate economic growth, without re-igniting inflationary pressures.

It is well known that Botswana's inflation is affected by domestic demand conditions and other factors such as foreign inflation, the exchange rate, as well as changes in administered prices and taxes. Public expectations of rising or falling inflation also influence pricing behaviour of businesses and wage adjustments. The Bank then responds by adjusting the Bank Rate and conducting open market operations to affect demand conditions in the economy and, ultimately, the rate of price changes. Therefore, the Bank estimates the impact of various factors in forecasting inflation over the medium term which, in turn, informs monetary policy. I wish to stress that, in this regard, the Bank's response to inflation forecasting is not mechanical; rather, it takes account of expert judgement and

supplementary analysis. For more information, I suggest you read the technical annex to this year's Monetary Policy Statement, copies of which will be made available at the end of my remarks.

With respect to *inflation trends and related developments in 2008*, you will recall that, for the first half of the year, global inflation was mostly driven by the steep increase in oil and food prices; the same applied to Botswana.

To put the situation in perspective, global inflation increased from 4.3 percent in 2007 to 6.4 percent in 2008; this affected the outlook for global economic growth, which slowed from 5.2 percent to 3.4 percent. As a result, international oil prices fell sharply in the latter half of the year, especially following the escalation of the global financial and economic crisis in September. The combined effect was that, thereafter, international inflation began to decline.

Here at home, inflation rose during most of 2008, and far exceeded the medium-term inflation objective of 3 – 6 percent at 15.1 percent in August, before declining to 13.7 percent at year-end. Although the average trade-weighted inflation in Botswana's trading partner countries was unchanged between 2007 and 2008 at 6.5 percent, inflation in

South Africa rose from an average of 6.5 percent in 2007 to 11.3 percent in 2008, and was well above the target range of 3 – 6 percent.

Successive increases in fuel prices contributed about 4.4 percentage points to domestic inflation between February and June 2008, but this was virtually reversed following fuel price reductions. Since August, inflation has fallen by less than expected due to a further increase in food prices and lingering second-round effects arising from the earlier period of oil price increases.

Bilateral exchange rates too had an impact on inflation in the year to December 2008. The Pula depreciated by about 20 percent against the Special Drawing Right (SDR), but it appreciated by 10 percent against the rand.

There was also rapid growth in government expenditure, which had accommodated the sharp increase in prices. With the higher development spending and the increase in civil service emoluments, it is estimated that fiscal year 2008/2009 will see government expenditure rising by approximately 43 percent over that of 2007/2008, which is triple the estimated initial spending increase of 14.7 percent.

In turn, the higher government expenditure and personal incomes led to an increase in private sector spending and credit. In the event, credit rose by about 32 percent in the year to September 2008, before slowing to 28 percent in December. Household borrowing increased by approximately 22 percent, while credit expansion to businesses more than doubled at 37 percent, thus reflecting the robust growth in the non-mining private sector during most of 2008. On the whole, however, overall GDP growth slowed due to the fall in mining output, a trend that continued into the first quarter of 2008/2009.

It is against this background that the *conduct of monetary policy in 2008* took account of various factors that influenced prices. For this reason, monetary policy action was not expected to have an immediate impact on inflation. Instead (and this is key), the policy focused on containing second-round price increases arising from the shock of food and oil prices; it also focused on keeping inflation expectations anchored around the price stability objective in the medium-term. Accordingly, as inflation rose in the first half of the year, the Bank Rate was increased by half a percentage point each in May and June 2008 to 15.5 percent.

With improvement in the inflation outlook, the Bank Rate was reduced by the same magnitude to 15 percent in December.

Correspondingly and as appropriate, commercial bank prime lending interest rates mirrored the Bank Rate adjustments; in addition, the management of excess bank liquidity reinforced the policy stance. Nevertheless, high inflation resulted in lower real interest rates, some of which, unfortunately, became negative in real terms.

With respect to the Bank's *outlook for inflation* for this year and a reasonable period ahead, both domestic and global inflation is expected to abate, as a result of lower economic activity and subdued demand. Commodity prices, including the cost of oil, are likely to be low, and world inflation is forecast to decrease from 6.4 percent in 2008 to 3.1 percent in 2009.

In South Africa, inflation is expected to decline to 5.5 percent in 2009, and fall within the 3 – 6 percent target range. Therefore, foreign prices will dampen domestic inflation. Since the Bank's inflation objective is 3 – 6 percent and trading partner countries' inflation is forecast at 3 – 5

percent, the downward crawl of the Pula should be marginal in 2009, and the real effective exchange rate should be stable.

Overall, economic performance is expected to slacken significantly, due to the depressed mining activity. It is also anticipated that despite the decline in government revenue, due to a fall in mining production, public spending will increase in support of economic growth. Nevertheless, it is estimated that output will be below trend, particularly in the short term. This should put downward pressure on inflation.

In this environment, it is unlikely that increased government spending will be inflationary, particularly in the absence of a public sector wage increase. However, it is worth mentioning that any large increase in administered prices, such as electricity tariffs and Botswana Housing Corporation rentals, would be inflationary. Be that as it may, the probability is that price increases will be subdued in 2009 compared to 2008. It is, therefore, anticipated that, by the end of the year, inflation will be closer to, if not within, the medium-term objective range of 3 – 6 percent.

Honoured Guests:

You may very well ask: What about the *monetary policy stance in 2009* in the circumstances! Well, we at the Bank consider that monetary policy action this year will take into consideration the following scenarios: first, the increase in government spending is unlikely to be inflationary; second, the exchange rate is expected to be stable; and third, it is hoped the inflation trend will continue to be downward. These developments suggest that there is scope for easing monetary policy alongside fiscal expansion, in order to address the imminent decline in economic activity.

It is also important to entrench expectations of low and sustainable inflation by containing the secondary effects of any transitory price shocks. Furthermore, care will have to be taken to ensure that the foreign exchange reserves remain sustainable.

Distinguished Ladies & Gentlemen:

Let me *conclude* by reiterating that monetary policy in 2008 was conducted in conditions of international volatility of unprecedented dimensions. Accelerating inflation in the first half of the year was replaced by the spectre of financial meltdown and global recession, and as a small open

economy, this situation presented enormous challenges for Botswana in 2008 and will continue to do so this year.

Fortunately, the task of meeting the inflation challenge has been made easier by the adoption of a more comprehensive medium-term framework for policy implementation, which has been made possible by ongoing capacity building in inflation forecasting.

Once again, I would like to reassure you, and all stakeholders, that the Bank of Botswana is committed to the maintenance of medium-term price stability due to its benefits for the country as a whole. In this regard, the key lesson from the current difficult international situation is that it pays to be prudent in financial and economic management. Otherwise, the Government would not have been able to accumulate savings in the form of foreign exchange reserves, which should enable the country to weather the unfolding storm.

Honourable Speaker, Honourable Ministers, Honourable Members of Parliament, Your Excellencies Members of the Diplomatic Corps, Distinguished Guests, that prudence; that

strategy; will continue to guide the conduct of monetary policy this year and in the period ahead.

I thank you for your attention.