Statement of the Monetary Policy Committee: October 26, 2010

1. Introduction

1.1 At the meeting of October 26, 2010, the Bank's Monetary Policy Committee concluded that the medium-term outlook for inflation was positive. However, the Committee anticipated that inflation will, in the short-term, be above the objective range due to the impact of the increase in Value Added Tax (VAT) and the previous upward adjustment in administered prices. It is, therefore, expected that inflation will fall within the 3 – 6 percent objective range in the second quarter of 2011. Following contraction in 2009, the domestic economy is projected to grow at a moderate rate in the short to medium-term, with below-trend output. Domestic output developments largely reflect similar prospects for world GDP.

2. Recent Economic and Policy Developments

2.1 The downside risk to global economic performance emanates from uncertain growth prospects in some major economies where commitment to fiscal consolidation to ensure long-term sustainability of government finances has the potential to moderate output expansion in the short-term. While the fragile economic recovery is still dependent on macroeconomic stimuli, the main focus is now on monetary policy stimulus to raise private sector demand and investment. Thus, in the latest round of policy decisions, some central banks reduced their policy interest rates and several others left the interest rates unchanged at very low levels, reflecting the need to nurture economic recovery, while measures to raise money supply through quantitative easing were undertaken in some instances.

2.2 Domestic inflation increased to 7 percent in September 2010, after falling for three consecutive months, and it remains above the upper end of the medium-term objective range of 3 – 6 percent. The increase in inflation mainly reflects the rise in the cost of transport, following the upward adjustment of public transport fares and increase in motor vehicle prices in September 2010. However, the underlying trend in inflation is restrained due to benign external price pressures and subdued domestic demand.

2.3 The level of output in the second quarter of 2010 is estimated to be 6.5 percent higher than in the same period in 2009, thus reflecting the 8 percent growth in mining output and the 5.8 percent increase for the non-mining sectors. Output is estimated to be below trend, with moderate pressures on inflation, against the background of subdued growth in the money supply that is due to a reduction in the level of foreign exchange reserves and a lower rate of increase in government expenditure compared to the previous year.

3. Economic Outlook and Assessment of Risks

3.1 World economic recovery is expected to continue in 2010, underpinned by robust growth in emerging markets, while recent developments in major economies have resulted in a downward revision of growth prospects. Overall, measures to consolidate the fiscal and public debt positions, as well as the need to implement enhanced financial sector supervisory measures, have the potential to slow down global growth. Moreover, output expansion in China, which has been a significant contributor to global growth, has plateaued. The world economy is projected to grow by 3.6 percent and 2.9 percent in 2010 and 2011, respectively after a 2.2 percent decline in 2009. In the context of low levels of capacity utilisation, high unemployment rate and well-anchored inflation expectations, it is anticipated that world inflation will be restrained.

3.2 In South Africa, economic growth is projected to stabilise around 3 percent for the rest of 2010, thus remaining below potential, and exerting limited pressure on inflation. The appreciation of the rand also contributes to low inflation pressures. There are, however, possible upside risks to the inflation outlook, including recent wage settlements that are above the inflation target and possible large increase in administered prices. The forecast is, nevertheless, for inflation to remain within the 3-6 percent target range in the medium term.

3.3 For Botswana, it is expected that non-mining GDP will remain below trend in the medium term. Although exporting sectors will benefit from recovery in world demand, growth in the domestic economy will be moderate due to reduced government spending. Moreover, it is anticipated that demand and its impact on economic activity will be subdued, reflecting sluggish growth in personal incomes and the increase in VAT, administered prices and other levies. The impact of the recent 10 percent adjustment of public sector wages on demand is expected to be modest. Nevertheless, the loosening of monetary policy in 2009 is supportive of expanding economic activity and will contribute to narrow the output gap in the medium-term.

3.4 Low domestic demand pressures and the forecast benign external inflationary pressures will add to the positive inflation outlook in the medium-term. Although inflation in the short-term is expected to remain above the objective range of 3 – 6 percent, it is forecast to be within the objective range on a sustained basis from the second quarter of 2011. The positive inflation outlook is influenced by the low pressures in South Africa and the dissipation of the impact of the increase in VAT and administered prices. There are, nevertheless, upside risks to inflation emanating from any substantial increase in administered prices and government levies. There is also uncertainty about international oil and food prices, which could potentially have an impact on the inflation outlook. Meanwhile, the Pula exchange rate is expected to be relatively stable with minimal effect on domestic prices.

4. Monetary Policy Stance

4.1 The current state of the economy and the assumptions on both the domestic and external economic outlook, as well as the inflation forecast, suggest that maintaining the prevailing level of interest rates is consistent with the achievement of the Bank's 3 – 6 percent inflation objective in the medium-term. Accordingly, the Monetary Policy Committee decided to maintain the Bank Rate at 10 percent.

4.2 In another policy development, the Primary Reserve Requirement for Pula denominated deposits at commercial banks has been raised from 5 percent to 6.5 percent with effect from November 1, 2010. Primary Reserves are the commercial banks' non-interest earning balances maintained at the Bank of Botswana. This decision is intended to reduce the amount of liquidity that is mopped up through Bank of Botswana Certificates. Given the amount of excess liquidity in the banking system, this measure will not constrain the supply of credit.

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