BANK OF BOTSWANA

ANNUAL REPORT

2008


BANK OF BOTSWANA
BANKA YA BOTSWANA

Board Members

as at December 31, 2008

L K Mohohlo
Governor and Chairman

G K Cunliffe

S S G Tumelo

H Siphambe

C S Botlhole-Mmopi

B Moeletsi

B B Bolele

B K Molosiwa

Board Members

as at December 31, 2008

L K Mohohlo
Governor and Chairman

S S G Tumelo

G K Cunliffe

B B Bolele

B Moeletsi

B K Molosiwa

C S Botlhole-Mmopi

H Siphambe

CONTENTS – PART A

2008 Statutory Report on the Operations and Financial Statements of the Bank

CONTENTS – PART B

Boxes, Charts, Figures and Tables

Tables

Abbreviations Used in The Report

ABC	African Banking Corporation
AGOA	Africa Growth and Opportunity Act
AIDS	Acquired Immunodeficiency Syndrome
BBS	Botswana Building Society
BDC	Botswana Development Corporation
BES	Business Expectations Survey
BIS	Bank for International Settlements
BISS	Botswana Inter-bank Settlement System
BMVAF	Botswana Motor Vehicle Accident Fund
BoB	Bank of Botswana
BoBCs	Bank of Botswana Certificates
BPSS	Botswana Payments and Securities Systems
BRL	Brazilian Real
BSB	Botswana Savings Bank
BURS	Botswana Unified Revenue Service
CDIS	Coordinated Direct Investment Survey
CIUs	Collective Investment Undertakings
CMA	Common Monetary Area
CPI	Consumer Price Index
CPIX	Consumer Price Index Excluding Mortgage Interest Rates
CSDB	Central Securities Depository Botswana
CSO	Central Statistics Office
DF	Development Fund
DPCF	Debt Participation Capital Funding Ltd
ECB	European Central Bank
ECHB	Electronic Clearing House of Botswana
ECU	European Currency Union
EFT	Electronic Funds Transfer
EMS	European Monetary System
EMU	European Monetary Union
ERM	Exchange Rate Mechanism
ESKOM	Electricity Supply Commission
EUR	Euro
FABI	Fleming Aggregate Bond Index
FAP	Financial Assistance Policy
FCAs	Foreign Currency Accounts
FED	Federal Reserve Bank
FIFA	Fédération Internationale de Football Association
FSAP	Financial Sector Assessment Programme
FSG	Funeral Service Group
FVTPL	Fair Value through Profit or Loss
GDP	Gross Domestic Product
HIV	Human Immunodeficiency Virus

IAS	International Accounting Standards
IASB	International Accounting Standards Board
ICT	Information and Communication Technology
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
IFSC	International Financial Services Centre
IIP	International Investment Position
IMF	International Monetary Fund
ISPAAD	Integrated Support Programme for Arable Agriculture Development
MFDP	Ministry of Finance and Development Planning
MPC	Monetary Policy Committee
MRIB	Medical Rescue International Botswana
NBFIRA	Non-Bank Financial Institutions Regulatory Authority
NDB	National Development Bank
NDP	National Development Plan
NEER	Nominal Effective Exchange Rate
NPS	National Payments System
OMO	Open Market Operations
PDSF	Public Debt Service Fund
PRGF/HIPC	Poverty Reduction Growth Facility/Highly Indebted Poor Country
REER	Real Effective Exchange Rate
REMCO	Remuneration Committee
RMCI	Real Monetary Conditions Index
RPI	Retail Price Index
RSF	Revenue Stabilisation Fund
RTGS	Real Time Gross Settlement
S&P	Standard and Poor's
SACU	Southern African Customs Union
SADC	Southern African Development Community
SARB	South African Reserve Bank
SDR	Special Drawing Right
SLF	Secured Lending Facility
SWIFT	Society for Worldwide Interbank Financial Telecommunication
UK	United Kingdom
USA	United States of America
USD	United States Dollar
VAT	Value Added Tax

Part A

Statutory Report on the Operations and Financial Statements of the Bank, 2008

Bank of Botswana

Deputy Governors
as at December 31, 2008

M D Pelaelo

O A Motshidisi

Heads of Department
as at December 31, 2008

N A Mabe
Accounting & Planning

A M Motsomi
Research

R H Nlebesi
Banking & Currency

O Mabusa
Banking Supervision

P Gundersen
Financial Markets (Acting)

J Ghanie
Technical Services

E T Rakhudu
Human Resources

O Modisa
Payments & Settlement

2008 STATUTORY REPORT ON THE OPERATIONS AND FINANCIAL STATEMENTS OF THE BANK

GOVERNOR'S FOREWORD

During 2008, the Bank's work programme was carried out in a challenging international and domestic environment brought about by the boom in commodity prices during most of the year, and followed by a global economic recession, as aggravated by the international financial crisis. Inflation rose steadily to a fourteen-year high of 15.1 percent in August, largely driven by high prices of petroleum and food as well as expansionary domestic demand.

In order to dampen inflation expectations, the Bank Rate was increased in May and June by a cumulative 1 percentage point to 15.5 percent. With the on-set of the global economic recession and the decline in commodity prices, inflation began to fall in the third quarter and its outlook improved. Accordingly, the Bank Rate was reduced to 15 percent in December 2008. A rolling 3-year inflation forecasting framework was introduced to guide a proactive and forward-looking monetary policy implementation to attain the medium-term inflation objective of 3 – 6 percent. The medium-term horizon should permit monetary policy action to have the desired effect.

The global economic recession and financial turmoil adversely affected the overall balance of payments due to, in the main, a sharp fall in diamond exports, slowdown in other inflows and an increase in external payments. As a result, the foreign exchange reserves declined by 7.1 percent from USD 9.8 billion in 2007 to USD 9.1 billion by year-end, which is equivalent to twenty-three months of imports of goods and services. Despite the international financial crisis, the domestic banking system expanded with a new entrant; it remained stable, sound and profitable, a development which continued to promote competition in both product and service delivery. Similarly, the non-bank financial sector continued to grow. Hence the supervisory surveillance of banks was strengthened, with a view to guarding against the adverse impact of the unfolding international financial and economic crisis.

In general, the Bank successfully carried out the work programme for the year, and this included providing policy advice to the Government on financial and economic matters.

The support of the Board as well as the dedicated service of the Management and staff were invaluable in discharging the Bank's mandate.

Linah K Mohohlo

GOVERNOR

STATUTORY REPORT ON THE OPERATIONS OF THE BANK IN 2008

THE BANK'S MISSION AND OBJECTIVES

As provided in the Bank of Botswana Act (Cap 55:01) Section (4) (1), the Bank's mission and main objectives are:

- to promote and maintain monetary stability, which primarily requires the maintenance of a low, predictable and sustainable inflation;
- to ensure that the overall financial system is safe and sound;
- to regulate and oversee the payment system and ensure that it is secure and efficient;
- in so far as it would not be inconsistent with monetary stability, to promote the orderly, balanced and sustainable economic development of the country.

CHART 1: MISSION, OBJECTIVES AND STRATEGIES

In order to attain these objectives, the Bank carries out various activities, in particular, the formulation and conduct of monetary policy with a view to maintaining a low, stable and predictable level of inflation. The Bank also has the mandate of regulating and supervising banks; providing banking services to the Government, commercial banks and selected public institutions; regulating and overseeing the payments system; and providing policy advice to the Government on economic and financial matters. Although these core functions are carried out by different Departments, they are inter-related as well as mutually re-enforcing and, together with the support of the corporate services areas of the Bank, create the necessary synergies for the Bank to fulfil its mandate.

The Bank's Organisational Structure

As prescribed under the Bank of Botswana Act (Cap 55:01), the Minister of Finance and Development Planning has overarching responsibility for the operations of the Bank and presents the Annual Report, on the operations and financial performance of the Bank to Parliament. The Bank's organisational structure comprises the Board, Governor, two Deputy Governors, eight Departments and three Divisions.

The Board

In accordance with the Bank of Botswana Act (Cap 55:01) and the Bank's Bye-Laws, the Board exercises overall authority and oversight in running the affairs of the Bank. The nine-member Board comprises the Governor (ex-officio and Chairman), the Permanent Secretary of the Ministry of Finance and Development Planning (ex-officio) and seven other members drawn from government, academia and the private sector. Both the Governor and two Deputy Governors are appointed by the President (the latter are not Board members). Other Board members are appointed by the Minister of Finance and Development Planning, only two of which may be public officers. The remaining members are appointed in their individual capacity from different occupational and professional backgrounds, except those expressly not permitted under the Law.

In 2008, the Board put in place a three-member Staff Remuneration Committee (REMCO) and reconfigured the Audit Committee, reducing its membership from the full Board to three; both committees comprise Non-Executive Board Members only. The REMCO is responsible for the review of remuneration and other conditions of service of staff and making recommendations, as appropriate, to the Board. The main responsibility of the Audit Committee is to ensure that the Bank's accounting policies, financial statements and disclosures conform to International Financial Reporting Standards (IFRS), as well as ensuring that Management puts in place an effective system of internal controls commensurate with the nature and complexity of the Bank's operations.

During the year, the Board held six meetings to oversee the Bank's delivery of its mandate and the execution of decisions, and to ensure compliance with financial and other administrative controls. The Board's key decisions included directing the Bank's strategic planning, determination of the broad operational framework, approval of the 2008 annual budget, monitoring the Bank's financial as well as operational performance and reviewing management and external auditors' reports.

The Governor

As Chairman (ex-officio) of the nine-member Board and Chief Executive Officer of the Bank, the Governor ensures prompt and efficient implementation of Board decisions and guidelines with the support of the Executive Committee. The Governor is also responsible for the Bank's relations with the Government, which includes submission of the Annual Report on the Bank's operations and the audited financial statements within three months of the end of the Bank's financial year, and the Banking Supervision Annual Report by June 30 each year to the Minister of Finance and Development Planning. Other duties include policy announcements on behalf of the Bank, and attending relevant local, regional and international gatherings, including representing the country on the Board of Governors of the International Monetary Fund (IMF).

The Executive Committee

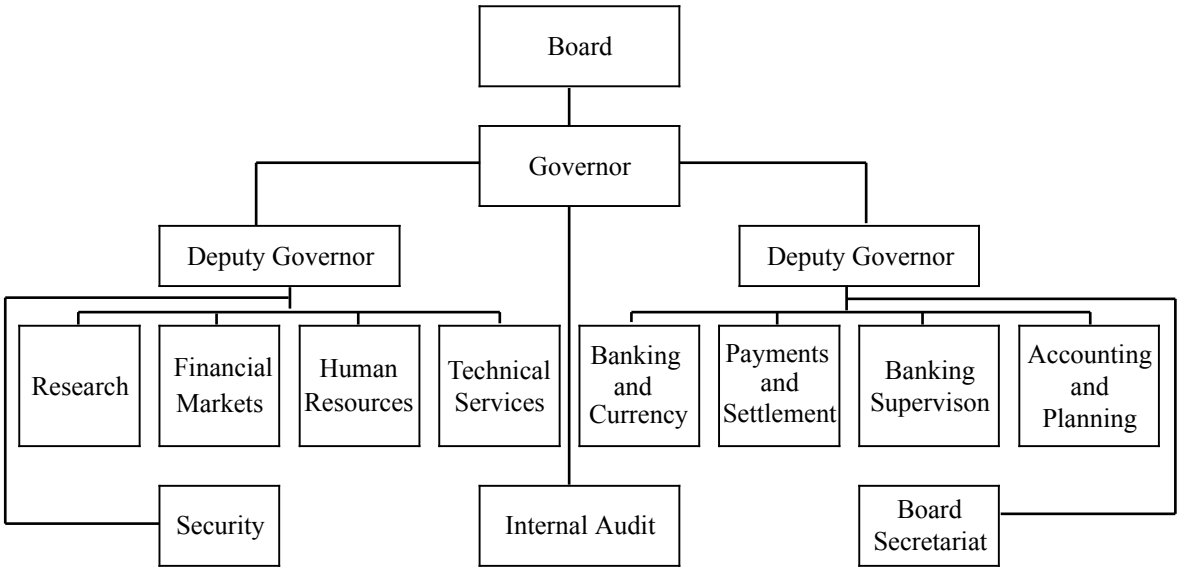
The Executive Committee comprises the Governor (Chairman), two Deputy Governors and eight Heads of Department; senior advisors may be co-opted members. The Committee, which meets each week, reviews progress made by Departments and Divisions in implementing work programmes approved by the Board in order to achieve the goals of the Bank's annual, medium- and long-term strategic plans.

Departments and Divisions

The Bank's eight Departments comprise Accounting and Planning, Banking and Currency, Banking Supervision, Financial Markets, Human Resources, Payments and Settlement, Research and Technical Services. The three Divisions are the Board Secretariat, Internal Audit and Security. The Heads of Department and two Divisions

report to the Governor through the Deputy Governors, while the Internal Audit Division reports directly to the Board and, on administrative matters, to the Governor.

CHART 2: ORGANISATIONAL STRUCTURE AS AT DECEMBER 31, 2008



REVIEW OF THE BANK'S MAIN ACTIVITIES IN 2008

In order to fulfil its mission and meet its objectives, the Bank carried out the following activities during 2008:

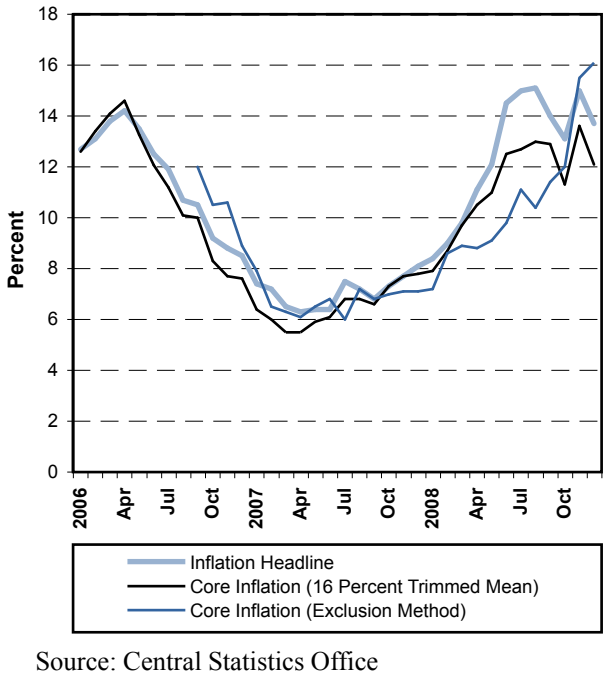
Monetary Policy

Monetary policy is conducted in order to maintain a low, stable and predictable level of inflation, which is a major component of what constitutes monetary stability.

In 2008, the Bank adopted a rolling three-year monetary policy framework in which the medium-term inflation objective is set. Therefore, the setting of a yearly inflation objective was discontinued. With effect from 2008, monetary policy action was guided by the medium-term inflation forecast, which is revised on a regular basis, taking into account a broad range of inflation determinants, including credit growth. Based on the new monetary policy framework, the 2008 Monetary Policy Statement announced a 3-6 percent medium-term inflation objective, a range that was reaffirmed following a review at mid-year.

During the first half of the year inflation rose rapidly to a peak of over 15 percent, the highest in fourteen years,

CHART 3: INFLATION INDICATORS, 2006 – 2008



Source: Central Statistics Office

due to a number of factors, including the rise in prices of food and fuel prices, as well as higher domestic demand (Chart 3). In an effort to restrain the second-round inflationary effects of the supply shocks and restrain spending while encouraging saving, the Bank Rate was increased by 50 basis points each in May and June to 15.5 percent.

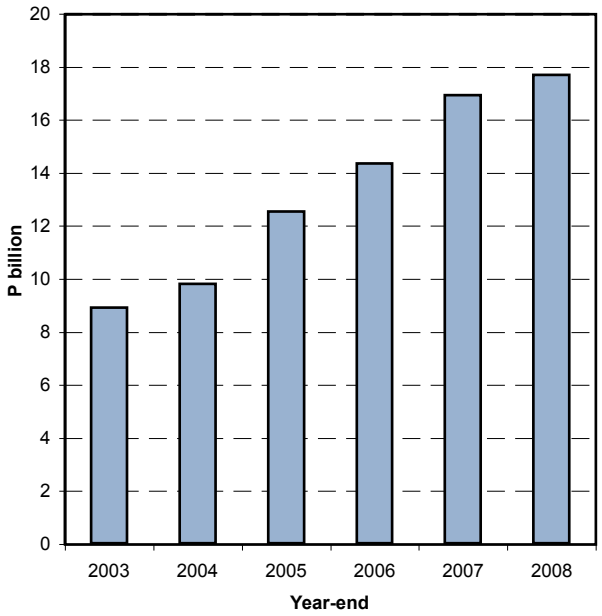
Inflation began to subside by mid-year due to a progressive fall in fuel prices and continued weakening of the global economy, resulting in an improvement in the inflation outlook. These developments prompted a reduction in the Bank Rate to 15 percent in December.

Money and Capital Markets

Throughout the year, the thrust of the monetary policy stance was supported by banking system liquidity management through weekly auctions of the Bank of Botswana Certificates (BoBCs), the outstanding amount of which was P17.6 billion at year-end (which is an increase of 5.6 percent compared to the 18.7 percent in 2007 - Chart 4). Liquidity was also managed through the daily conduct of repurchase agreements (repos) and reverse repos. The turnover of repos rose by 3 percent over 2007, while the corresponding increase was 67.9 percent for reverse repos; the latter reflected the high level of liquidity in the banking system. For the year as a whole, the average inter-bank rate fell marginally to 11.03 percent in 2008 from an average of 11.09 percent in the previous year.

As a fiscal agent of the Government, the Bank issued government bonds in March and September 2008 under the P5 billion Government Note Issue programme launched in March 2008. The total nominal value of the issuance in March and September was P1.3 billion and P700 million, respectively. When maturity is taken into account, the total outstanding Government Notes amounted to P2.6 billion as at the end of the year. The Government's objective in issuing bonds and Treasury bills included a further development of the primary and secondary money and capital markets.

Chart 4: Bank of Botswana Certificates Outstanding, December 31, 2003 - 2008



Source: Bank of Botswana

Nominal interest rates in the banking system were adjusted in response to the changes in the Bank Rate. However, the high level of inflation reduced real interest rates significantly, some of which turned negative during the year. The real prime rate fell from 7.31 percent in December 2007 to 2.46 percent in December 2008, while both the real 88-day deposit rate and the real three-month BoBC yield were negative at -4.55 percent and -0.50 percent, respectively, at year end, thus reversing the respective positive interest rates of 0.38 percent and 3.58 percent the year before (Chart 5).

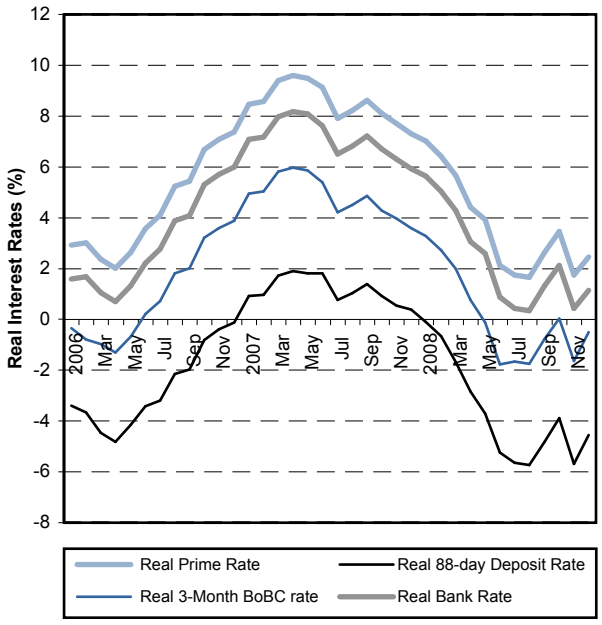
Foreign Exchange Market and Exchange Rate Policy

Over the twelve-month period, the exchange rate movements of the Pula against major trading currencies were mixed. In nominal terms, the Pula appreciated significantly against the rand and the pound sterling, but depreciated against the US dollar, the euro and the yen. During the year, the Bank was a net seller of foreign exchange to banks mainly due to the payment of diamond export-related payments to the Government directly into the Bank's accounts with overseas correspondent banks. However, the volume of net sales rose towards the end of the year due to the global economic downturn which, in turn, reduced mineral export

receipts, resulting in a rise in average net monthly sales from P788.8 million in 2007 to P1 359.6 million in 2008. Most foreign exchange sales were in the South African rand, while purchases were predominantly in US dollars.

Due to the high level of domestic inflation compared with that of trading partner countries, the 18.2 percent nominal depreciation of the Pula against the SDR was reduced to a 7.7 percent real depreciation, and the nominal 10 percent appreciation against the rand turned into a 14.3 percent real appreciation. As a result, the downward crawl of the nominal effective exchange rate (NEER) during 2008 did not offset the inflation differential between Botswana and trading partners, resulting in a 4.5 percent appreciation of the real effective exchange rate (REER), a reversal of the 1 percent depreciation in 2007 (Chart 6).

CHART 5: SELECTED KEY REAL INTEREST RATES

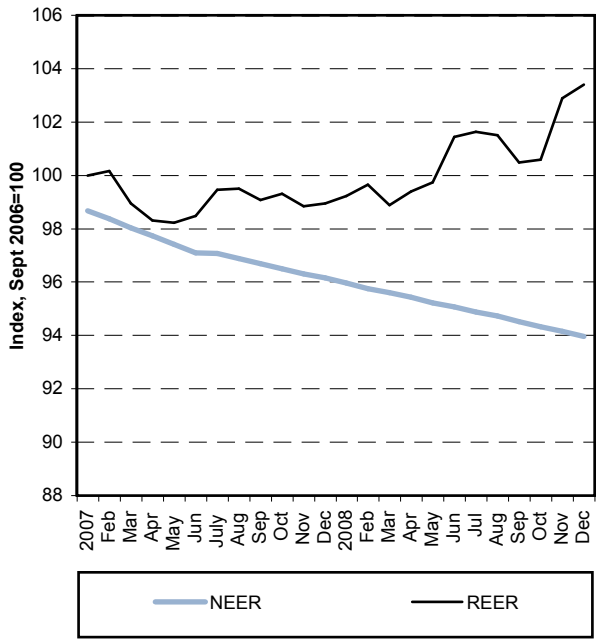


Source: Bank of Botswana

Banking Supervision and Regulation

Domestic banks were stable, well managed, profitable and virtually unaffected by the turbulence in the international financial markets. Compliance with supervisory, prudential and corporate governance requirements was monitored through on- and off-site examinations, combined with regular meetings with banks. The Bank's supervisory and regulatory framework was strengthened further with the establishment of a Regulatory Policy Committee, which is responsible for advising on the issuance of regulatory and supervisory guidelines to enhance transparency in the conduct of commercial banking business. Although the Non-Bank Financial Institutions Regulatory Authority (NBFIRA) commenced operations in April 2008, the Bank continued to regulate and supervise the International Financial Services Centre (IFSC), Collective Investment Undertakings (CIUs) and some other non-bank entities on a care-taker basis. The full transfer of supervisory responsibility of these institutions to NBFIRA is expected to be completed before the end of 2009.

CHART 6: NOMINAL AND REAL EFFECTIVE EXCHANGE RATES (2007 – 2008)



Source: Bank of Botswana

Access to banking services improved further through the commencement of operations of Capital Bank, expansion of branch networks and competitive product diversification. Overall, the banking system balance sheet grew by 22 percent during the 2008 financial year, which is a repeat of the 2007 experience. As a result of new entrants, the establishments in the IFSC increased from the previous year's 16 to 21. In addition, a number of licences were granted for CIUs services as well as trusteeship and fund management. The number of bureaux de change businesses also increased from 46 to 50.

Table 1 provides a summary of key prudential norms against which the performance of the banking system is monitored. All key prudential ratios showed a solvent and sound banking system.

TABLE 1: BANKING SYSTEM SOUNDNESS AND PRUDENTIAL STANDARDS, 2006 - 2008

	Prudential Standard (Percent)	Range of Performance Standards for Banks (Percent)		
		2006	2007	2008
Capital Adequacy	≥ 15	15.6 – 35.5	15.2 – 36.9	15.8 – 32.5
Liquid Asset Ratio	≥ 10	53.5 – 67.8	22.0 – 63.0	30.7 – 56.2
Profitability (Return on Assets)	Positive	1.2 – 4.8	0.6 – 4.6	1.0 - 8.1
Profitability (Return on Equity)	Positive	17.5 – 78.7	6.2 – 66.0	12.9 – 57.2
Asset Quality (Non- Performing Loans/Total Loans)	≤ 2.5	2.8 – 22.2	2.2 – 27.1	2.3 – 17.9
Intermediation Ratio (Advances/Deposits)	≥ 50	32.9 – 51.3	32.3 – 81.2	37.0 – 77.1

Source: Bank of Botswana and Commercial Banks

Central Banking Services

The stock of P20 banknotes was replenished and the issuance of currency met demand throughout the year. Compared to the previous year, the demand for currency by denomination was largest for the P10 note, which increased by 32.3 percent, followed by the P100 note (23.5 percent). There was no change in the volume of issuance of the P50 note, while the demand for the P20 denomination declined by 6.9 percent. For coin, the issuance of the P5, P2, 50 thebe and 10 thebe slowed considerably, while there was an increase with respect to the P1, 25 thebe and 5 thebe coin.

TABLE 2: CURRENCY IN CIRCULATION AS AT END DECEMBER, 2007 - 2008

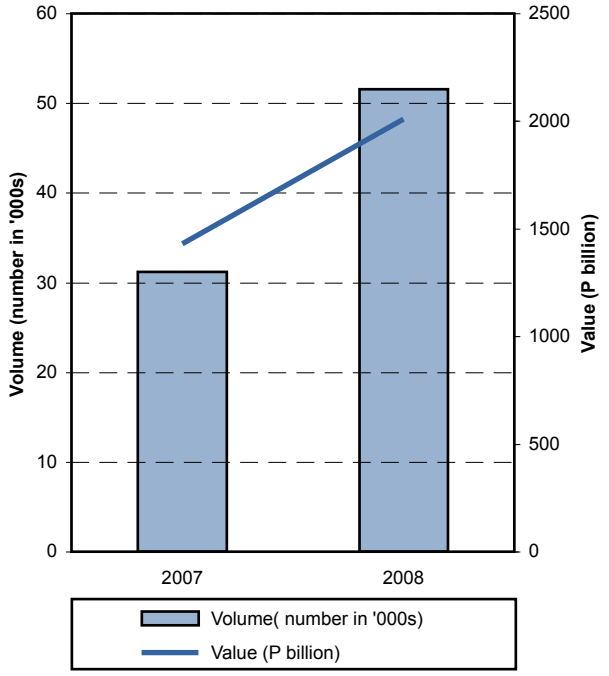
Bank Notes (Number in millions)				Coin (Number in millions)			
	2007	2008	2007 – 2008 (Percent Change)		2007	2008	2007 – 2008 (Percent Change)
P100	9.8	12.1	23.5	**P5**	4.8	5.1	6.3
P50	3.2	3.2	0.00	**P2**	8.1	8.9	9.9
P20	5.8	5.4	-6.9	**P1**	13.3	16.0	20.3
P10	3.1	4.1	32.3	**50t**	13.3	14.8	11.3
				25t	19.1	23.5	23.0
				10t	50.6	50.9	0.6
				5t	99.2	119.7	20.7

Source: Bank of Botswana

Payments System

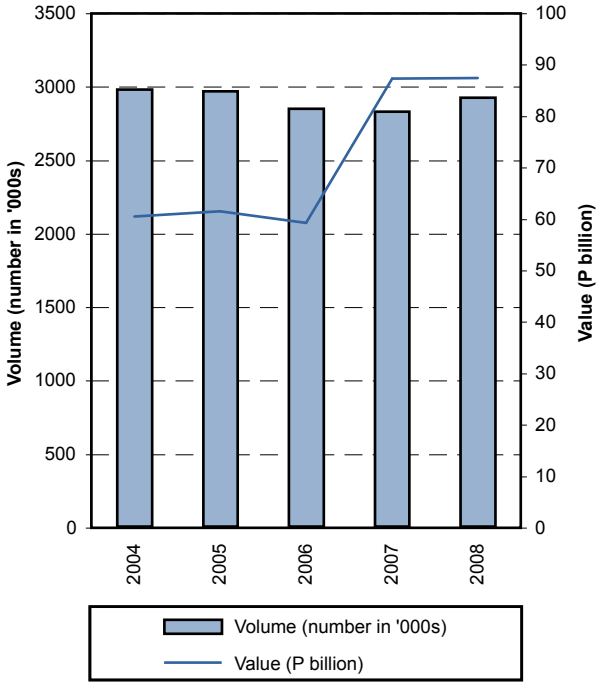
The Bank is responsible for the secure operations and regulation of the National Payments System (NPS), which comprises the Botswana Inter-bank Settlement System (BISS), a Real Time Gross Settlement System (RTGS) that provides settlement services for the Botswana Payments and Securities Systems (BPSS), and the Electronic Clearing House of Botswana (ECHB), which clears cheques and Electronic Funds Transfers (EFTs). Over the past 12 months, the volumes and values of payments transactions settled in the BISS increased by 65.4 percent and 40.3 percent, respectively (Chart 7). Over the same period, cheque processing at the ECHB increased by 3.4 percent in volume and 0.2 percent in value (Chart 8). Corresponding increases for Electronic Funds Transfers were 15.3 percent in volume and 62.3 percent in value, and this indicated a significant shift towards the more secure electronic means of payment which are settled through the BISS (Chart 9). The Society for Worldwide Inter-bank Financial Telecommunication (SWIFT) system was upgraded to improve security, efficiency and connectivity with correspondent banks and other counterparties. The NPS continued to function in accordance with the requirements of the Bank for International Settlements Core Principles for Systemically Important Payments Systems. Participants in the payments system increased with the introduction of the Central Securities Depository Botswana (CSDB), which is operated by the Botswana Stock Exchange together with other new entrants.

CHART 7: BOTSWANA INTER-BANK SETTLEMENT SYSTEM TRANSACTIONS, 2007 - 2008



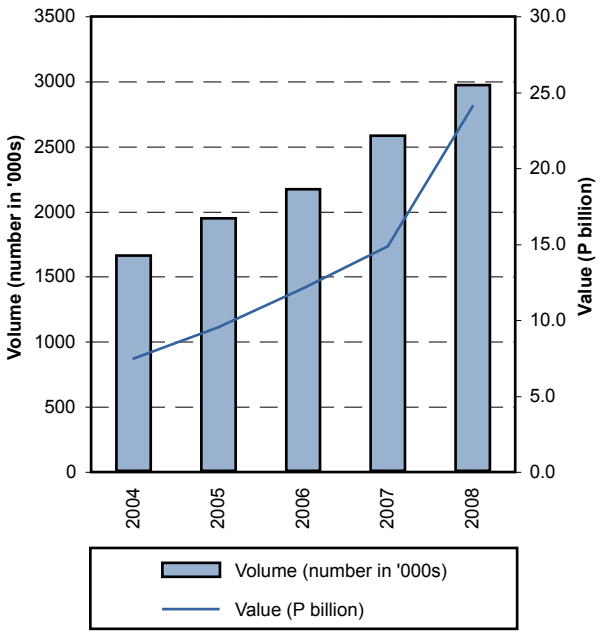
Source: Bank of Botswana

CHART 8: ELECTRONIC CLEARING HOUSE: CHEQUE PROCESSING, 2004 - 2008



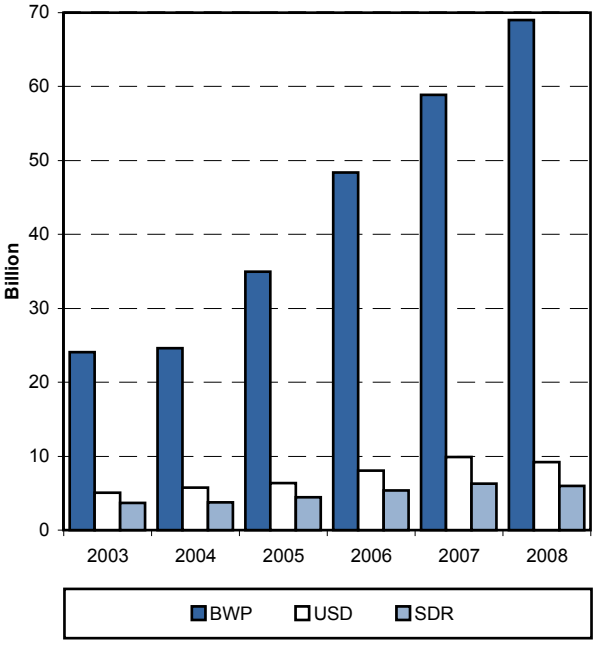
Source: Electronic Clearing House

CHART 9: ELECTRONIC CLEARING HOUSE: ELECTRONIC TRANSFERS, 2004 – 2008



Source: Electronic Clearing House

CHART 10: FOREIGN EXCHANGE RESERVES, 2003 – 2008



Source: Bank of Botswana

Foreign Exchange Reserves Management

The foreign exchange reserves increased by 17.2 percent from P58.5 billion in 2007 to P68.6 billion in 2008, reflecting mainly the depreciation of the Pula against the currencies of the major trading partner countries. In US dollar and SDR terms, however, the foreign exchange reserves declined by 7.1 percent and 4.8 percent to

USD9.1 billion and SDR5.9 billion, respectively. The decrease in the foreign currency value of the reserves was mainly due to realised and unrealised asset value losses on the investments in the international financial markets and a significant decrease in diamond exports receipts due to the global economic downturn, as well as an increase in import payments.

The Bank's investment policies and guidelines, alongside the regular consultations with fund managers, continued to be robust in ensuring the safety and prudent management of the country's foreign exchange investment portfolio. As at the end of the year, the foreign exchange reserves provided cover for 23 months worth of imports of goods and services.

Relations with Government and Other Stakeholders

Publications and Public Education

As legally required, the Bank's *2007 Annual Report* and the *2007 Banking Supervision Annual Report* were submitted to the Minister of Finance and Development Planning on March 31, 2008 and June 30, 2008, respectively. The *2008 Monetary Policy Statement* was launched early in the year. Both the Mid-term Review of the Monetary Policy Statement and the monthly *Botswana Financial Statistics* continued to be published and posted on the Bank's website. The theme for the Annual Report was *Botswana's Framework for Macroeconomic and Financial Stability in Support of Sustainable Economic Growth.* Outreach and information dissemination activities included economic briefings of the Cabinet and senior government officials, chief executives of parastatals, private sector corporations and commercial banks, as well as media representatives and other stakeholders on the highlights of the *2007 Annual Report* and other activities of the Bank**.** The Bank also participated in several other public education activities, including exhibitions and school career fairs.

Advisory Functions

The Bank carried out the various advisory services to the Government, primarily on financial and economic policy issues. This was facilitated through, inter alia, the membership of various inter-agency committees.

External Relations

Regional Central Bank Cooperation

Within the Africa region, the Bank attended meetings and conferences of the Southern African Development Community (SADC) Committee of Central Bank Governors (CCBG) and the Association of African Central Banks (AACB).

International Financial and Other Institutions

The Bank also attended the meetings of the Bank for International Settlements (BIS) and the Joint Annual Meetings of the International Monetary Fund (IMF) and the World Bank.

The IMF continued to provide the Bank with capacity building technical assistance for inflation forecasting and improvements in statistics. As in previous years, the Bank coordinated the annual reviews by credit rating agencies, Moody's Investors Service and Standard and Poor's, both of which reaffirmed the A/A-1 rating for foreign currency sovereign credit rating and investment grade rating for local currency rating, despite the worsening global economic outlook.

ADMINISTRATION AND CORPORATE SERVICES

Staffing

The Bank's staff establishment in 2008 was 580, and the vacancy rate was reduced from 6.7 percent to 5.3 percent. The Bank continued to undertake training and staff development programmes to meet its human resource needs. Staff motivation and welfare continued to be provided through on-going review of conditions of service and health support facilities, including the programme for combating HIV/AIDS in the work place. For the year ending September 30, 2007, the Staff Pension Fund dividends were declared at 36.8 percent and 31.69 percent for active and deferred members, respectively; and good relations between the Central Bank Staff Union and the Management were maintained.

Physical Projects, Information Technology and Risk Mitigation

Construction of Phase 1 of the Bank's Sports Facility was completed in September, while the upgrading of Technical Security at the Bank's headquarters in Gaborone was finalised in July. More generally, installation of new equipment and upgrading of information technology systems enhanced the efficiency of a number of operations, including the integrated payroll and personnel management systems. The satisfactory results for the disaster recovery planning tests on all mission critical systems at the disaster recovery site augur well for the Bank's readiness to deal with a major disaster. The firewall upgrading, which began the previous year, was completed in 2008, and an intrusion prevention system was installed.

Twenty-six scheduled internal audits and four special audits were conducted; and the adequacy of internal controls, as well as the effectiveness of the Control Risk Self-Assessment programme, was evaluated. Moreover, the Bank continued to cooperate with law enforcement agencies in combating currency counterfeiting.

ANNUAL FINANCIAL STATEMENTS

2008

BANK OF BOTSWANA

CONTENTS

STATEMENT OF RESPONSIBILITY OF THE BOARD AND APPROVAL OF FINANCIAL STATEMENTS

The members of the Board are responsible for the preparation of the annual financial statements in accordance with International Financial Reporting Standards and in the manner required by the Bank of Botswana Act (CAP 55:01).

The auditors are responsible to give an independent opinion on the fairness of the annual financial statements based on their audit of the affairs of the Bank in accordance with International Standards on Auditing.

After making enquiries the Board has no reason to believe that the Bank will not be a going concern in the foreseeable future. For this reason they continue to adopt the going concern basis in preparing the financial statements.

The members of the Board are satisfied that Management introduced and maintained adequate internal controls to ensure that dependable records exist for the preparation of the annual financial statements, to safeguard the assets of the Bank and to ensure they are duly authorised.

Against this background, the members of the Board accept responsibility for the annual financial statements and the information on pages 31 to 63 which were approved on March 27, 2009 and are signed on its behalf by:

Linah K Mohohlo
Governor

Gordon K Cunliffe
Board Member

Deloitte

PO Box 778
Gaborone
Botswana

Deloitte & Touche
Assurance & Advisory Services
Certified Public Accountants
(Botswana)
Deloitte & Touche House
Plot 50664
Fairgrounds Office Park
Gaborone
Botswana

Tel: +(267) 395 1611
Fax: +(267) 397 3137
www.deloitte.com

INDEPENDENT AUDITOR'S REPORT

TO THE MEMBERS OF THE BOARD OF BANK OF BOTSWANA

We have audited the annual financial statements of Bank of Botswana, set out on pages 31 to 63, which comprise the balance sheet as at December 31, 2008, the income statement, cash flow statement and statement of changes in shareholder's funds for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Board Members' Responsibility for the Financial Statements
The members of the Board are responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards and in the manner required by the Bank of Botswana Act (CAP 55:01).

This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility
Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion
In our opinion, the financial statements present fairly, in all material respects, the financial position of Bank of Botswana as of December 31, 2008, and of its financial performance, statement of changes in shareholder's funds and its cash flows for the year ended in accordance with International Financial Reporting Standards and in the manner required by the Bank of Botswana Act (CAP 55:01).

Deloitte & Touche

Deloitte & Touche
Certified Public Accountants

March 27, 2009
GABORONE

BALANCE SHEET

DECEMBER 31, 2008

	Notes	2008 P'000	2007 P'000
ASSETS			
Property and Equipment	1	147 645	143 070
Foreign Exchange Reserves			
Liquidity Portfolio	2.1	16 358 184	18 389 216
Pula Fund	2.2	51 626 106	39 722 003
International Monetary Fund (IMF)			
Reserve Tranche	3.1	97 891	41 832
Holdings of Special Drawing Rights	3.2	457 728	365 366
Administered Funds	3.4	71 814	–
Total Foreign Exchange Reserves		68 611 723	58 518 417
Government of Botswana Bonds	4	41 019	89 045
Other Assets	5	92 086	93 485
TOTAL ASSETS		68 892 473	58 844 017
LIABILITIES			
Notes and Coin in Circulation	6	1 593 970	1 360 906
Bank of Botswana Certificates	7	17 553 915	16 616 216
Deposits	8	3 065 303	2 383 694
Allocation of Special Drawing Rights (IMF)	3.3	50 756	41 594
Liabilities to Government (IMF Reserve Tranche)	9	97 891	41 832
Dividend to Government	10	325 500	226 500
Other Liabilities	11	56 778	61 676
Total Liabilities		22 744 113	20 732 418
SHAREHOLDER'S FUNDS			
Paid-up Capital	14	25 000	25 000
Government Investment Account			
Pula Fund and Liquidity Portfolio		30 519 444	26 983 118
Currency Revaluation Reserve		12 509 032	7 532 007
Market Revaluation Reserve		1 494 884	1 971 474
General Reserve	15	1 600 000	1 600 000
Total Shareholder's Funds		46 148 360	38 111 599
TOTAL LIABILITIES AND SHAREHOLDER'S FUNDS		68 892 473	58 844 017
FOREIGN EXCHANGE RESERVES IN US DOLLARS[1] (000)		9 118 498	9 790 131
FOREIGN EXCHANGE RESERVES IN SDR[2] (000)		5 941 775	6 191 249
[1] United States dollar/Pula		0.1329	0.1673
[2] SDR/Pula		0.0866	0.1058

INCOME STATEMENT

YEAR ENDED DECEMBER 31, 2008

	Notes	2008 P'000	2007 P'000
INCOME			
Interest – Foreign exchange reserves	16	2 491 908	2 105 953
Dividends – Foreign exchange reserves	17	282 431	235 545
Interest – Government of Botswana Bonds		5 814	8 829
Net market gains on disposal of securities	18	–	670 143
Net realised currency gains	19	7 428 337	1 690 973
Net unrealised currency gains	20	3 116 805	36 788
Net unrealised market gains	21	118 586	47 580
Profit on domestic foreign exchange deals		399 786	306 376
Other income		26 800	19 709
		13 870 467	5 121 896
EXPENSES			
Interest expense	22	2 127 809	1 901 234
Administration costs		278 485	223 639
Depreciation expense	1	12 723	12 604
Net market losses on disposal of securities	18	526 234	–
		2 945 251	2 137 477
NET INCOME FOR THE YEAR		10 925 216	2 984 419
TRANSFER TO CURRENCY REVALUATION RESERVE	23	(10 069 289)	(1 721 539)
NET INCOME AVAILABLE FOR DISTRIBUTION		855 927	1 262 880
TRANSFERS FROM/(TO) GOVERNMENT INVESTMENT ACCOUNT		446 073	(356 880)
		1 302 000	906 000
APPROPRIATIONS			
Dividend to Government		(1 302 000)	(906 000)

CASH FLOW STATEMENT

YEAR ENDED DECEMBER 31, 2008

	Notes	2008 P'000	2007 P'000
OPERATING ACTIVITIES			
Cash generated by operations	26	2 478 683	4 114 063
INVESTING ACTIVITIES			
Net investments		(569 450)	(9 151 931)
Proceeds on redemption of Government of Botswana bonds (at cost)		98 537	–
Interest received from Government of Botswana bonds		7 521	8 846
Proceeds from disposal of property and equipment		296	227
Purchase of property and equipment	1	(17 632)	(11 180)
Purchase of Government of Botswana bonds		(59 221)	–
NET CASH USED IN INVESTING ACTIVITIES		(539 949)	(9 154 038)
FINANCING ACTIVITIES			
Dividend to Government	10	(1 203 000)	(817 000)
Government (Withdrawals)/Investments		(968 798)	5 565 788
NET CASH (USED IN)/GENERATED FROM FINANCING ACTIVITIES		(2 171 798)	4 748 788
NET INCREASE IN CURRENCY IN CIRCULATION		(233 064)	(291 187)
CURRENCY IN CIRCULATION AT THE BEGINNING OF THE YEAR		(1 360 906)	(1 069 719)
CURRENCY IN CIRCULATION AT THE END OF THE YEAR		(1 593 970)	(1 360 906)

STATEMENT OF CHANGES IN SHAREHOLDER'S FUNDS

YEAR ENDED DECEMBER 31, 2008

	Paid-up Capital P'000	Currency Revaluation Reserve P'000	Market Revaluation Reserve P'000	General Reserve P'000
Balance at January 1, 2007	25 000	6 610 393	2 081 721	1 600 000
Transfer from Income Statement	–	1 721 539	–	–
Net unrealised currency losses on non-monetary "available-for-sale" financial instruments	–	(26 412)	–	–
Net unrealised market losses for the year on "available-for-sale" financial instruments	–	–	(290 893)	–
Transfers to Government Investment Account:				
Net unrealised market losses for the year	–	–	180 646	–
Net unrealised currency gains for the year	–	(773 513)	–	–
Government investment	–	–	–	–
Net gains not recognised in the Income Statement for the year	–	921 614	(110 247)	–
Net income for the year	–	–	–	–
Transfer to Currency Revaluation Reserve	–	–	–	–
Dividend to Government from Pula Fund	–	–	–	–
Transfers to/(from) the Income Statement for the year:				
Excess of Government Pula Fund Income over Pula Fund Dividend	–	–	–	–
To cover residual deficit	–	–	–	–
Balance at December 31, 2007	25 000	7 532 007	1 971 474	1 600 000
Transfer to Income Statement of realised market gains on redemption of Government Bond BW002	–	–	(6 494)	–
Transfer from Income Statement	–	10 069 289	–	–
Net unrealised currency gains on non-monetary "available-for-sale" financial instruments	–	1 214 535	–	–
Net unrealised market losses for the year on "available-for-sale" financial instruments	–	–	(1 825 698)	–
Transfers to Government Investment Account:				
Net unrealised market losses for the year	–	–	1 355 602	–
Net unrealised currency gains for the year	–	(6 306 799)	–	–
Government withdrawal		–	–	–
Net gains not recognised in the Income Statement for the year	–	4 977 025	(476 590)	–
Net income for the year	–	–	–	–
Transfer to Currency Revaluation Reserve	–	–	–	–
Dividend to Government from Pula Fund	–	–	–	–
Transfers to the Income Statement for the year:				
Deficit of Government Pula Fund Income over Pula Fund Dividend	–	–	–	–
Balance at December 31, 2008	25 000	12 509 032	1 494 884	1 600 000

1. The Government Investment Account which was established on January 1, 1997 represents the Government's portion of the Pula Fund and the Liquidity Portfolio.

Government Investment Account P'000	Accumulated Profit P'000	Total P'000	
20 467 583	–	30 784 697	**Balance at January 1, 2007**
–	–	1 721 539	Transfer from Income Statement
–	–	(26 412)	Net unrealised currency losses on non-monetary "available-for-sale" financial instruments
–	–	(290 893)	Net unrealised market losses for the year on "available-for-sale" financial instruments
			Transfers to Government Investment Account:
(180 646)	–	–	Net unrealised market losses for the year
773 513	–	–	Net unrealised currency gains for the year
5 565 788	–	5 565 788	Government investment
6 158 655	–	6 970 022	**Net gains not recognised in the Income Statement for the year**
–	2 984 419	2 984 419	Net income for the year
–	(1 721 539)	(1 721 539)	Transfer to Currency Revaluation Reserve
–	(906 000)	(906 000)	Dividend to Government from Pula Fund
			Transfers to/(from) the Income Statement for the year:
413 831	(413 831)	–	Excess of Government Pula Fund Income over Pula Fund Dividend
(56 951)	56 951	–	To cover residual deficit
26 983 118	–	38 111 599	**Balance at December 31, 2007**
–	–	(6 494)	Transfer to Income Statement of realised market gains on redemption of Government Bond BW002
–	–	10 069 289	Transfer from Income Statement
–	–	1 214 535	Net unrealised currency gains on non-monetary "available-for-sale" financial instruments
–	–	(1 825 698)	Net unrealised market losses for the year on "available-for-sale" financial instruments
			Transfers to Government Investment Account:
(1 355 602)	–	–	Net unrealised market losses for the year
6 306 799	–	–	Net unrealised currency gains for the year
(968 798)	–	(968 798)	Government withdrawal
3 982 399	–	8 482 834	**Net gains not recognised in the Income Statement for the year**
–	10 925 216	10 925 216	Net income for the year
–	(10 069 289)	(10 069 289)	Transfer to Currency Revaluation Reserve
–	(1 302 000)	(1 302 000)	Dividend to Government from Pula Fund
			Transfers to the Income Statement for the year:
(446 073)	446 073	–	Deficit of Government Pula Fund Income over Pula Fund Dividend
30 519 444	–	46 148 360	**Balance at December 31, 2008**

SIGNIFICANT ACCOUNTING POLICIES

DECEMBER 31, 2008

BASIS OF PRESENTATION OF FINANCIAL STATEMENTS

The financial statements are prepared on the historical cost basis as modified to include the revaluation of investments in domestic and foreign assets and liabilities. The principal accounting policies stated below have been consistently applied and comply with International Financial Reporting Standards in all material respects.

NEW AND REVISED STANDARDS AND INTERPRETATIONS

No new or revised Standards and Interpretations issued by the International Accounting Standards Board and the International Financial Reporting Interpretations Committee (the IFRIC) relevant to the Bank's operations were effective for annual reporting periods beginning on January 1, 2008.

STANDARDS IN ISSUE BUT NOT YET ADOPTED

At the date of finalisation of the financial statements the following revised Standards relevant to the Bank's operations were in issue and are effective for annual periods beginning on or after January 1, 2009:

- The amended version of IAS 1: Presentation of Financial Statements was issued (in 2007). The adoption of the revised standard will expand the required disclosures in the financial statements;
- On May 22, 2008 the International Accounting Standards Board (IASB) issued its latest Standard, titled Improvements to International Financial Reporting Standards 2008. This is the first Standard published under the IASB's annual improvements process which is intended to deal with non-urgent, minor amendments to Standards. The Standards includes 35 amendments, comprising of editorial or terminology changes to standards as well as amendments that will result in accounting changes for presentation, recognition and measurement purposes; and
- Amendments to IFRS 7: Financial Instruments: Disclosures were issued in March 2009. These amendments are intended to enhance disclosures around liquidity risk management and fair valuation of financial instruments.

The adoption of these changes will not have an impact on the Bank's financial results but will result in amendments to the presentation and disclosures in the annual financial statements.

FINANCIAL INSTRUMENTS

General

Financial instruments carried on the Balance Sheet include all assets and liabilities, including derivative instruments, but exclude property and equipment.

Financial Assets

Financial assets are classified into the following specified categories: financial assets as "at fair value through profit or loss" (FVTPL) (including held for trading), "available-for-sale" and "loans and receivables". The classification depends on the nature and purpose of the financial assets and is determined at the time of initial recognition as detailed below.

Financial assets measured as at "FVTPL" are stated at fair value, with any resultant gain or loss recognised in the Income Statement. The net gain or loss recognised in profit or loss incorporates any dividend or interest earned on the financial asset.

SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)
December 31, 2008

Short-term Investments (Liquidity Portfolio)

The Bank has designated the Liquidity Portfolio as a fund in which money market instruments and bonds are invested to facilitate payments for regular transactions.

Securities invested in this portfolio are measured "at fair value through profit or loss" and are classified as held for trading. They are initially recognised at cost and are subsequently remeasured at market value based on bid prices. All related realised and unrealised gains and losses are recognised in the Income Statement.

All purchases and sales of investment securities in the portfolio are recognised at trade date, which is the date the Bank commits to purchase or sell the investments.

Long-term Investments (Pula Fund)

This is a long-term fund intended to maximise returns and is invested in foreign financial instruments with a long-term duration. These investments, which may be sold in response to needs for liquidity, changes in interest rates, exchange rates, etc. are classified as "available-for-sale", except for derivatives. These securities are initially recognised at cost (which includes transaction costs) and are subsequently remeasured at market value, based on bid prices.

All realised market and currency gains/losses are taken to the Income Statement. Unrealised currency gains/losses on monetary items are recognised in the Income Statement and those on non-monetary items are reported in the Statement of Changes in Shareholder's Funds. In line with the Bank's policy, exchange gains/losses for this fund are not distributable and are, therefore, appropriated to the Currency Revaluation Reserve.

Unrealised revaluation gains and losses arising from changes in the market value of the instruments classified as "available-for-sale" are recognised in the Market Revaluation Reserve. When these instruments are disposed of or impaired, the related accumulated market value or impairment adjustments are included in the Income Statement as gains or losses from investment securities.

All purchases and sales of investment securities in the portfolio are recognised at trade date, which is the date the Bank commits to purchase or sell the investments.

Government of Botswana Bonds

The Bank acquires Government of Botswana Bonds for purposes of facilitating orderly trading in the local bond market. The bonds, which may be sold in response to needs to intervene in the market, are classified as "available-for-sale" securities.

The bonds are initially recognised at cost and are subsequently remeasured at market value, based on bid prices. All unrealised gains and losses arising from changes in the market value are recognised in the Market Revaluation Reserve. When these instruments are disposed of or impaired, the related accumulated market value adjustments are included in the Income Statement as gains or losses from Government of Botswana Bonds.

All regular purchases and sales of bonds are recognised at trade date, which is the date that the Bank commits itself to purchase or sell the bonds.

Derivative Financial Instruments

The Bank uses a variety of derivative financial instruments to manage its exposure to interest rate and foreign

SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)
December 31, 2008

exchange risk, including foreign exchange forward contracts and cross-currency swaps.

Derivative financial instruments are initially recognised at cost (including transaction costs) and are subsequently remeasured at market value, based on bid prices for assets held or liabilities to be issued, and ask/offer prices for assets to be acquired or liabilities held. The resulting gain or loss is recognised in the Income Statement.

Impairment of Financial Assets

Financial assets other than loans and receivables are carried at fair value. "Loans and receivables" are assessed for any evidence of impairment at each balance sheet date. Financial assets are impaired when there is objective evidence that as a result of one or more events that have occurred after the initial recognition of the financial asset, the estimated future cash flows of the investment have been adversely impacted. For financial assets carried at amortised cost, the amount of the impairment is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the original effective interest rate. In respect of "available-for-sale" equity securities, any increase in fair value subsequent to an impairment loss is recognised directly in shareholder's funds.

Financial Liabilities

All the Bank's financial liabilities are classified as other financial liabilities at amortised cost.

Bank of Botswana Certificates

As one of the primary tools for maintaining monetary stability in the economy, the Bank of Botswana issues its own paper, Bank of Botswana Certificates (BoBCs), to absorb excess liquidity in the market and thereby to influence short term interest rates. BoBCs are issued at a discount to counterparties. They are classified as "other financial liabilities".

The Bank's liability in respect of BoBCs is stated at offer prices on auction date, adjusted for movements in matured and unmatured discount recognised in the Income Statement.

Other Financial Liabilities

Other financial liabilities are initially measured at fair value, net of transaction costs.

Other financial liabilities are subsequently measured at amortised cost using the effective interest rate method, with interest expense recognised on the effective yield basis. The effective interest method is a method of calculating the amortised cost of a financial liability and of allocating interest expense over the relevant period. The effective interest rate is the rate that exactly discounts future cash payments through the expected life of the financial liability, or where appropriate, a shorter period.

SECURED LENDING FACILITY

Under the Secured Lending Facility (SLF), the Bank provides emergency and intermittent funding to solvent financial institutions, intended to bridge overnight liquidity shortages. The advances are secured by Government of Botswana Bonds and Bank of Botswana Certificates (BoBCs), valued at market prices on the date of the transaction. The Bank has the right to call for additional collateral, should the value of the security decline during the tenure of the facility. Interest earned on the advances is credited to the Income Statement, while advances outstanding as at the Balance Sheet date are recorded under the heading "Advances to Banks".

SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)
December 31, 2008

SECURITIES LENDING PROGRAMME

The Bank takes part in a Securities Lending Programme. Where securities are lent, the Bank holds collateral in the form of cash or other securities. The securities lent continue to be recorded in the Bank's balance sheet.

The Bank's global custodian administers the Securities Lending Programme and monitors the securities lent and related collateral against requirements agreed by the Bank.

The Bank records income from lending securities as it accrues.

REPURCHASE AND REVERSE REPURCHASE AGREEMENTS

This facility is one of the mechanisms designed to deal with short-term liquidity fluctuations in the domestic money market. It is available to primary counterparties who are solvent institutions licensed and supervised by the Bank.

Securities purchased under agreement to resell (Reverse Repurchase Agreement) are recorded as funds receivable under the heading "Advances to Banks", except for where the securities are BoBCs. In such instances, the advances are netted off against outstanding BoBCs liabilities.

Only high quality, marketable and freely transferable paper with a minimum amount of risk is acceptable as collateral at the discretion of the Bank. Government and Government guaranteed securities of any maturity and other eligible paper with a remaining maturity of 184 days or less are also acceptable as security.

Securities sold under agreement to repurchase (Repurchase Agreement) are recorded and disclosed as Deposits.

The term of a repurchase agreement and reverse repurchase agreement can vary from overnight to one month, depending on the liquidity conditions in the domestic market.

Interest earned by the Bank on repurchase agreements is credited to the Income Statement, while interest paid by the Bank on reverse repurchase agreements is charged to the Income Statement.

FOREIGN CURRENCIES

All transactions denominated in foreign currencies are translated to Pula at the bid rates of exchange for all sales, and offer rates of exchange for all purchases, at the transaction date.

Where amounts denominated in one foreign currency are sold in order to buy other foreign denominated currency such that neither profit nor loss is realised on the transaction, mid exchange rates are used.

All monetary assets and liabilities denominated in foreign currencies are translated to Pula using the bid and offer rates of exchange, respectively, at the close of the financial year. All exchange gains/losses realised on disposal of financial instruments and unrealised exchange gains/losses arising on translation of monetary items are included in the Income Statement. However, all gains and losses relating to disposals whose proceeds are reinvested in foreign assets, and unrealised gains/losses arising on monetary financial instruments are not considered distributable in terms of Bank policy; they are appropriated to the Currency Revaluation Reserve. All unrealised exchange gains/losses on translation of non-monetary "available-for-sale" assets are reported in the Statement of Changes in Shareholder's Funds, until the financial assets are derecognised, at which time the cumulative gains/losses previously recognised in Shareholder's Funds are recognised in the Income Statement.

SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)
December 31, 2008

ASSETS, LIABILITIES AND RECOGNITION OF PROVISIONS

Assets

Assets are recognised when the Bank obtains control of a resource as a result of past events, and from which future economic benefits are expected to flow to the Bank.

Contingent Assets

The Bank discloses a contingent asset arising from past events where it is probable that economic benefits will flow from it, but this will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events outside the control of the Bank.

Liabilities and Provisions

The Bank recognises liabilities (including provisions) when:

(a) it has a present legal obligation resulting from past events;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle this obligation; and

(c) a reliable estimate of the amount of the obligation can be made.

Derecognition of Assets and Liabilities

The Bank derecognises a financial asset when it loses control over the contractual rights that comprise the asset and transfers substantially all the risks and benefits associated with the asset. This arises when the rights are realised, expire or are surrendered. A financial liability is derecognised when it is legally discharged.

INCOME AND EXPENSE RECOGNITION

Interest income and expense and dividend income are recognised in the Income Statement on an accrual basis.

OFFSETTING FINANCIAL INSTRUMENTS

The Bank offsets financial assets and liabilities and reports the net balance in the Balance Sheet where:

(a) there is a legally enforceable right to set off;

(b) there is an intention to settle on a net basis or to realise the asset and settle the liability simultaneously;

(c) the maturity date for the financial assets and liability is the same; and

(d) the financial asset and liability are denominated in the same currency.

GENERAL RESERVE

Under Section 7(1) of the Bank of Botswana Act, (CAP 55:01), the Bank of Botswana is required to establish and maintain a General Reserve sufficient to ensure the sustainability of future operations of the Bank. The Bank may transfer to the General Reserve funds from other reserves, which it maintains, for the purposes of maintaining the required level of the General Reserve.

SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)
December 31, 2008

CURRENCY REVALUATION RESERVE

Any changes in the valuation, in terms of Pula, of the Bank's assets and liabilities in holdings of Special Drawing Rights and foreign currencies as a result of any change in the values of exchange rates of Special Drawing Rights or foreign currencies and in realised currency gains reinvested in foreign assets are transferred to the Currency Revaluation Reserve.

The proportion directly attributable to the Government Investment Account is transferred to such investment account.

MARKET REVALUATION RESERVE

Any changes in the value of the Bank's long-term investments as a result of any change in the market values of such investments are transferred to the Market Revaluation Reserve.

The proportion directly attributable to the Government Investment Account is transferred to such investment account.

PROPERTY AND EQUIPMENT

Property and equipment are stated at cost less related accumulated depreciation and any accumulated impairment losses.

Land and buildings are valued on a fair value basis every two years, and the recoverable (revalued) amounts disclosed by way of a Note to the Financial Statements, providing that revalued amounts are in excess of the carrying amounts. Where the carrying amounts are more than the revalued amounts, an impairment loss is recognised in the Income Statement.

At each balance sheet date, the Bank reviews the carrying amounts of its tangible and intangible assets to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss (if any).

Any impairment loss is recognised immediately in the Income Statement.

Where an impairment loss subsequently reverses, the carrying amount of the asset is increased to the revised estimate of its recoverable amount, but so that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognised for the asset in prior years.

Depreciation

Depreciation is charged so as to write-off the cost or valuation of assets, other than land and buildings under construction, over their estimated useful lives, using the straight-line method. The estimated useful lives, residual values and depreciation methods are reviewed at each year end, with the effect of any changes in estimate accounted for on a prospective basis.

The annual depreciation rates used in the calculation of depreciation are as follows:

	Percent
Buildings	2.5
Furniture, fixtures and equipment	5 – 50
Computer hardware	25
Computer software	20
Motor vehicles – Commercial	20 – 25
– Bullion Truck	5

SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)
DECEMBER 31, 2008

A gain or loss arising on disposal or retirement of an item of property and equipment is determined as the difference between the net sales proceeds and the carrying amount of the asset and is recognised in the Income Statement.

RETIREMENT BENEFITS

Pension benefits are provided for employees through the Bank of Botswana Defined Contribution Staff Pension Fund, which is governed in terms of the Pension and Provident Funds Act (CAP 27:03). The contribution per pensionable employee is at the rate of 21.5 percent which comprises 16 percent and 1.5 payable by the Bank as its contribution to the Fund and for administration costs of the Fund, respectively, and a 4 percent contribution by each pensionable employee. Other than the contributions made, the Bank has no commitments or obligations to this Fund.

FINANCE LEASES

The Bank classifies leases of land, property and equipment where it assumes substantially all the benefits and risks of ownership as finance leases. Finance leases are capitalised at the estimated net present value of the underlying lease payments. The Bank allocates each lease payment between the liability and finance charges to achieve a constant periodic rate of interest on the finance balances outstanding for each period. The interest element of the finance charges is charged to the income statement over the lease period. The land, property and equipment acquired under finance leases are depreciated over the useful lives of the assets, on the basis consistent with similar property and equipment.

RELATED PARTY TRANSACTIONS

The Bank enters into various transactions with other wholly owned or partly owned Government institutions and its key management personnel (related parties). All related party transactions are entered into at arm's length in the ordinary course of business. The exposure to key management personnel are staff benefits provided for in the General Conditions of Service of the Bank.

SIGNIFICANT ACCOUNTING ESTIMATES AND JUDGEMENTS IN APPLYING ACCOUNTING POLICIES

The Bank makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgments are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

Useful Lives of Property and Equipment

Management reviews the estimated useful lives of plant and property at the end of each annual reporting period. In this financial year, no change was made to the useful lives, hence the depreciation rates provided are similar with the prior year.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS

DECEMBER 31, 2008

1. PROPERTY AND EQUIPMENT

	Freehold Land	Leasehold Land	Buildings	Capital Works in Progress	Other Assets	Total
	P'000	P'000	P'000	P'000	P'000	P'000
Cost – 2008						
Balance at the beginning of the year	607	3 659	140 721	5 817	92 190	242 994
Reclassification	173	(173)	–	–	–	–
Additions	–	–	–	12 365	5 267	17 632
Disposals	–	–	–	–	(14 854)	(14 854)
Transfers	–	882	256	(1 138)	–	–
Balance at year–end	780	4 368	140 977	17 044	82 603	245 772
Accumulated Depreciation						
Balance at the beginning of the year	–	–	40 683	–	59 241	99 924
Charge for the year	–	–	3 518	–	9 205	12 723
Disposals	–	–	–	–	(14 520)	(14 520)
Balance at year–end	–	–	44 201	–	53 926	98 127
Net book value at December 31, 2008	780	4 368	96 776	17 044	28 677	147 645
Cost – 2007						
Balance at the beginning of the year	607	3 486	137 702	3 651	89 032	234 478
Additions	–	–	–	6 010	5 170	11 180
Disposals	–	–	–	–	(2 664)	(2 664)
Transfers	–	173	3 019	(3 844)	652	–
Balance at year–end	607	3 659	140 721	5 817	92 190	242 994
Accumulated Depreciation						
Balance at the beginning of the year	–	–	37 204	–	52 540	89 744
Charge for the year	–	–	3 479	–	9 125	12 604
Disposals	–	–	–	–	(2 424)	(2 424)
Balance at year–end	–	–	40 683	–	59 241	99 924
Net book value at December 31, 2007	607	3 659	100 038	5 817	32 949	143 070

Revaluation of Properties

Freehold and leasehold land and buildings were valued by an independent professional property valuer in December 2008 at an open market value of P179 460 000 (2007: P152 000 000).

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2008

	2008 P'000	2007 P'000
2. FOREIGN EXCHANGE RESERVES		
2.1 Liquidity Portfolio		
Bonds – held for trading	4 835 556	2 825 919
Amounts Due from Pula Fund	1 359 185	946 093
Cash and Cash Equivalents	10 163 443	14 617 204
	16 358 184	18 389 216
2.2 Pula Fund		
Equities – available-for-sale	8 305 959	11 148 040
Bonds – available-for-sale	41 371 065	25 387 681
Derivative Financial Instruments – assets (Note 13)	2 344	12 396
Amounts Due to Liquidity Portfolio	(1 359 185)	(946 093)
Derivative Financial Instruments – liabilities (Note 13)	(27 178)	(7 358)
Cash and Cash Equivalents	3 333 101	4 127 337
	51 626 106	39 722 003
Pula Fund Balance Sheet		
Capital Employed		
Government	30 455 753	26 483 118
Bank of Botswana	21 170 353	13 238 885
	51 626 106	39 722 003
Employment of Capital		
Investments	51 626 106	39 722 003
Investments expressed in US dollars ('000)	6 861 109	6 645 491
Investments expressed in SDR ('000)	4 470 820	4 202 588

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)
DECEMBER 31, 2008

		2008 P'000	2007 P'000
2.	**FOREIGN EXCHANGE RESERVES (Continued)**		
2.3	**Pula Fund Income Statement**		
	Income		
	Interest and dividends	1 831 760	1 474 435
	Realised market gains	–	661 864
	Realised currency revaluation gains	5 181 996	1 365 980
	Unrealised currency revaluation gains	2 644 041	90 732
	Sundry income	–	25
		9 657 797	3 593 036
	Expenses		
	Realised market losses	(561 630)	–
	Administration charges	(100 923)	(83 307)
		(662 553)	(83 307)
	Net income for the year	8 995 244	3 509 729
	Transfer to Currency Revaluation Reserve	(7 826 037)	(1 456 712)
	Net income before transfer from Government Investment Account	1 169 207	2 053 017
	Transfer from/(to) Government Investment Account	446 073	(356 880)
	Net income available for distribution	1 615 280	1 696 137
	Appropriations		
	Dividend to Government	(1 302 000)	(906 000)
	Bank of Botswana's share of net income	313 280	790 137

3. INTERNATIONAL MONETARY FUND (IMF)

3.1 Reserve Tranche

This asset represents the difference between Botswana's Quota in the IMF and IMF Holdings of Pula. Botswana's Quota is the membership subscription, of which at least 25 percent was paid for in foreign currencies and the balance in Pula. The holding of Pula by the IMF, which initially was equal to 75 percent of the quota, has changed from time to time as a result of the use of the Pula by the IMF in lending to member countries.

Quota (SDR 63 000 000)	727 483	595 463
Less IMF Holdings of Pula	(629 592)	(553 631)
Reserve Position in IMF	97 891	41 832

The IMF Holdings of Pula are represented by the Non-Interest Bearing Note of P165 324 000 (2007: P165 324 000) issued by the Government of Botswana in favour of the IMF, maintenance of value currency adjustments and the amount in the current account held at the Bank (included in other deposits in Note 8).

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2008

	2008 P'000	2007 P'000
3. INTERNATIONAL MONETARY FUND (IMF) (Continued)		
3.2 Holdings of Special Drawing Rights		
The balance on the account represents the value of Special Drawing Rights (SDR) allocated and purchased less utilisation to date.	457 728	365 366
3.3 Allocation of Special Drawing Rights (IMF)		
This is the liability of the Bank to the IMF in respect of the allocation of SDRs to Botswana	50 756	41 594
3.4 Administered Funds		
This relates to the Poverty Reduction Growth Facility/Heavily Indebted Poor Countries (PRGF/HIPC) Trust. The amount represents SDR 6 217 983 (and interest accrued thereon) lent on May 20, 2008, to the Poverty Reduction Growth Facility/Heavily Indebted Poor Countries Trust Fund, a fund administered in trust by the IMF. This matures on May 20, 2013.	71 814	–
4. GOVERNMENT OF BOTSWANA BONDS – available-for-sale		
(i) Government Bond BW002 purchased on March 31, 2003, matured on March 1, 2008, bearing interest at the rate of 10.25 percent, receivable semi-annually in arrears:		
Market value	–	86 080
Interest accrued	–	2 965
	–	89 045
(ii) Government Bond BW004 purchased on March 7, 2008, maturing on March 12, 2011 bearing interest at the rate of 10.50 percent, receivable semi-annually in arrears:		
Market value	19 884	–
Interest accrued	644	–
	20 528	–
(iii) Government Bond BW005 purchased on September 10, 2008, maturing on September 12, 2018, bearing interest at the rate of 10 percent, receivable semi-annually in arrears:		
Market value	19 877	–
Interest accrued	614	–
	20 491	–
	41 019	89 045
5. OTHER ASSETS		
Staff loans and advances	73 368	62 626
Prepayments	1 769	1 552
Other	16 949	29 307
	92 086	93 485

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2008

	2008 P'000	2007 P'000
6. NOTES AND COIN IN CIRCULATION		
Notes	1 510 415	1 285 932
Coin	83 555	74 974
	1 593 970	1 360 906
Notes and coin in circulation held by the Bank as cash in hand at the end of the financial year have been netted off against the liability for notes and coin in circulation to reflect the net liability to the public.		
7. BANK OF BOTSWANA CERTIFICATES – Other financial liabilities		
Face Value	17 642 140	16 878 820
Unmatured Discount	(88 225)	(262 604)
Carrying Amount	17 553 915	16 616 216
Bank of Botswana Certificates are issued at various short-term maturity dates and discount rates. Netted off against the carrying amount is P340.5 million of BoBCs which were repurchased from counterparties as at December 31, 2008 (2007: P403.6 million).		
8. DEPOSITS		
Government	865 924	708 631
Bankers	1 478 879	1 066 563
Other	720 500	608 500
	3 065 303	2 383 694
These represent current accounts of Government, commercial banks, parastatal bodies and others, which are repayable on demand and are interest free except for the Debswana Tax Holding Account (see note 31).		
9. LIABILITIES TO GOVERNMENT (IMF RESERVE TRANCHE)		
This balance represents the Bank's liability to the Government in respect of the Reserve Tranche position in the IMF (Note 3.1).	97 891	41 832
10. DIVIDEND TO GOVERNMENT		
Balance due at the beginning of the year	226 500	137 500
Dividend to Government from Pula Fund	1 302 000	906 000
Paid during the year	(1 203 000)	(817 000)
Balance due at the end of the year	325 500	226 500
The final instalment of the pre-set dividend of P325 500 unpaid as at December 31, 2008 was provided for in accordance with Section 6 of the Bank of Botswana Act (CAP 55:01), which requires that all profits of the Bank be distributed to the shareholder, the Government.		
11. OTHER LIABILITIES		
Accounts payable	4 187	1 547
Other creditors and accruals	52 591	60 129
	56 778	61 676

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2008

	2008 P'000	2007 P'000
12. CATEGORIES OF FINANCIAL INSTRUMENTS		
Financial Assets		
Held for trading		
Bonds	4 835 556	2 825 919
Derivative Financial Instruments	2 344	12 396
Available-for-sale		
Bonds	41 371 065	25 387 681
Equities	8 305 959	11 148 040
Government Bonds	41 019	89 045
Loans and Receivables		
IMF Reserves	627 433	407 198
Staff loans and advances	73 368	62 626
Cash and cash equivalents	13 496 544	18 744 541
Total Financial Assets	68 753 288	58 677 446
The above is disclosed in the balance sheet as follows:		
Total Foreign Exchange Reserves	68 611 723	58 518 417
Add: Derivative Financial Instruments (liabilities)	27 178	7 358
Government of Botswana Bonds	41 019	89 045
Other Assets - staff loans and advances (Note 5)	73 368	62 626
Total	68 753 288	58 677 446
Financial Liabilities		
Held for trading		
Derivative Financial Instruments	27 178	7 358
Other Financial Liabilities - at Amortised Cost		
Bank of Botswana Certificates	17 553 915	16 616 216
Allocation of SDR (IMF)	50 756	41 594
Liabilities to Government (IMF)	97 891	41 832
Deposits	3 065 303	2 383 694
Dividend to Government	325 500	226 500
Other Liabilities	56 778	61 676
Total Financial Liabilities	21 177 321	19 378 870

Fair Values

The fair value of all financial assets and liabilities are substantially identical to the carrying amounts reflected in the balance sheet.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2008

13. DERIVATIVE FINANCIAL INSTRUMENTS

The Bank's investment guidelines authorise the use of derivative instruments. The derivatives are held for managing risk. The Table below shows the market values and the total notional exposures of derivative financial instruments as at year end.

		Asset 2008 (P'000)	Liabilities 2008 (P'000)	Notional Amount 2008 (P'000)	Assets 2007 (P'000)	Liabilities 2007 (P'000)	Notional Amount 2007 (P'000)
Fixed Income Futures	-Buy	–	(20 406)	1 405 133	–	(7 358)	1 238 633
	-Sell	–	(4 895)	(186 510)	6 591	–	(388 633)
Fixed Income Options	-Buy	–	–	–	–	–	–
	-Sell	–	–	–	290	–	(646)
Currency Futures	-Buy	–	–	–	2 768	–	292 552
	-Sell	479	–	(38 986)	14	–	(70 833)
Currency Options	-Buy	–	–	–	2 699	–	12 912
	-Sell	848	–	(848)	34	–	(42)
Other Options	-Buy	–	–	–	–	–	–
	-Sell	–	(1 877)	(941)	–	–	–
Swaps	-Buy	565	–	1 891	–	–	–
	-Sell	452	–	(2 415)	–	–	–
Total		2 344	(27 178)	1 177 324	12 396	(7 358)	1 083 943

The above derivatives are classified by type of asset and derivative instruments. The assets and liabilities reflect the net position between the market values and the notional amounts.

Futures

A futures contract is an agreement executed on the floor of an exchange to buy or sell a specific amount of a security or cash at a specified price and time. A fixed income futures contract would be an agreement to either buy or sell a specified amount of a fixed income security at a specified price and date, while a currency futures contract will be an agreement to either buy or sell a specified amount of currency at a specified exchange rate and date. Futures contracts are collateralised by cash or marketable securities and changes in the futures contract value are settled daily.

Options

An option is an exclusive right, usually obtained for a fee, but not the obligation to buy or sell a specific financial instrument within a specified time. A fixed income option is the exclusive right to either buy or sell specified units of a fixed income security by a specific date. A currency option is an option to either buy or sell a specified currency by a specific date.

Swaps

A swap is an agreement between two or more parties to exchange sets of cash flows over a period in the future, typically either in the form of interest rate swaps or currency swaps. The cash flows that the counterparties make are linked to the value of the underlying debt financial instrument or the foreign currency, as the case may be.

	2008 P'000	2007 P'000
14. PAID-UP CAPITAL		
Authorised and Paid-up Capital	25 000	25 000

The capital is the amount subscribed by the Government in accordance with Section 5 of the Bank of Botswana Act (CAP 55:01). The Bank is not subject to any externally imposed capital requirements. Therefore, capital is not actively managed. Management considers the Paid-up Capital and the General Reserve to be capital.

15. GENERAL RESERVE		
In the opinion of the Board, the General Reserve, taken together with other reserves which the Bank maintains, is sufficient to ensure the sustainability of future operations of the Bank.	1 600 000	1 600 000

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2008

	2008 P'000	2007 P'000
16. INTEREST – FOREIGN EXCHANGE RESERVES		
Liquidity Portfolio		
Cash and cash equivalents	758 892	692 438
Bonds – held for trading	172 210	158 684
IMF Reserves – loans and receivables	11 477	15 916
Pula Fund		
Cash and cash equivalents	128 986	189 682
Bonds – available-for-sale	1 420 343	1 049 233
Total	2 491 908	2 105 953
17. DIVIDENDS – FOREIGN EXCHANGE RESERVES		
Pula Fund		
Equities – available-for-sale	282 431	235 545
18. NET MARKET (LOSSES) GAINS ON DISPOSAL OF SECURITIES		
Liquidity Portfolio		
Bonds – held for trading	35 396	8 279
Pula Fund		
Derivative instruments – held for trading	147 409	52 682
Bonds – available-for-sale	310 159	(51 137)
Equities – available-for-sale	(1 019 198)	660 319
Total	(526 234)	670 143
Included above are net market losses of P709 039 000 (2007: P609 182 000 gains) which have been recycled from equity on disposal of investments classified as available-for-sale.		
19. NET REALISED CURRENCY GAINS		
Liquidity Portfolio		
Cash and cash equivalents	1 963 549	350 321
Bonds – held for trading	282 792	(32 064)
IMF - loans and receivables	–	6 734
Pula Fund		
Derivative instruments – held for trading	1 280	32 570
Cash and cash equivalents	690 703	165 110
Bonds – available-for-sale	3 468 245	877 519
Equities – available-for-sale	1 021 768	290 783
Total	7 428 337	1 690 973

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2008

	2008 P'000	2007 P'000
20. NET UNREALISED CURRENCY GAINS		
Liquidity Portfolio		
Cash and cash equivalents	(49 761)	5 697
Bonds – held for trading	443 009	(88 473)
IMF reserves - loans and receivables	79 516	14 104
Pula Fund		
Cash and cash equivalents	(47 142)	35 761
Bonds – available-for-sale	2 751 792	72 761
Derivative instruments – held for trading	(60 609)	(3 062)
Total	3 116 805	36 788
21. NET UNREALISED MARKET GAINS		
Liquidity Portfolio		
Bonds – held for trading	83 893	39 775
Pula Fund		
Derivative instruments – held for trading	34 693	7 805
Total	118 586	47 580
22. INTEREST EXPENSE		
Bank of Botswana Certificates (BoBCs)	2 062 237	1 838 783
Debswana Tax Holding Account (Note 31)	33 255	43 426
Reverse Repurchase Agreements	32 317	19 025
	2 127 809	1 901 234
23. NET CURRENCY REVALUATION GAINS RECOGNISED IN THE INCOME STATEMENT		
Total net realised gains (Note 19)	7 428 337	1 690 973
Total net unrealised gains (Note 20)	3 116 805	36 788
Total net currency revaluation gains taken to the Income Statement	10 545 142	1 727 761
Appropriated to Currency Revaluation Reserve:		
Net realised and reinvested in foreign assets	(6 952 484)	(1 684 751)
Net unrealised currency gains	(3 116 805)	(36 788)
Transferred to Currency Revaluation Reserve	(10 069 289)	(1 721 539)
Net currency revaluation gains retained in the Income Statement	475 853	6 222

24. CONTRIBUTION TO THE BANK OF BOTSWANA DEFINED CONTRIBUTION STAFF PENSION FUND

The Bank's contribution to the Bank of Botswana Defined Contribution Staff Pension Fund for the year ended December 31, 2008 is P13 099 000 (2007: P10 265 000).

25. CASH FLOW STATEMENT

The definition of cash in IAS 7 is not wholly appropriate to the Bank. Due to its role in the creation and withdrawal of currency in circulation, the Bank has no cash balances on its balance sheet (also see Note 6). However, the Bank has the ability to create cash when needed.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2008

	2008 P'000	2007 P'000
26. CASH GENERATED BY OPERATIONS		
Net income for the year	10 925 216	2 984 419
adjusted for:		
Net realised and unrealised exchange gains	(10 069 289)	(1 721 539)
Depreciation expense	12 723	12 604
Loss on disposal of property and equipment	38	13
Interest – Government of Botswana Bonds	(5 814)	(8 829)
Operating cash flows before movements in working capital	862 874	1 266 668
Increase in Deposits – banks and other	524 316	203 019
Increase in Deposits – Government	157 293	45 563
Increase in Bank of Botswana Certificates	937 699	2 613 525
Decrease/(Increase) in other assets	1 399	(19 732)
(Decrease) Increase in other liabilities	(4 898)	5 020
Cash generated by operations	2 478 683	4 114 063
27. CAPITAL COMMITMENTS		
Approved and contracted for	19 592	14 427
Approved, but not contracted for	22 288	35 866
	41 880	50 293

These capital commitments will be funded from internal resources.

28. COLLATERAL

(i) **Secured Lending Facility**

There were no open positions under the Secured Lending Facility at the year-end, hence no "Advances to Banks" and corresponding collateral held by the Bank at the balance sheet date.

(ii) **Securities Lending Programme**

Under the Bank's Securities Lending Programme, the Bank has lent securities with a fair value of P11.3 billion (2007: P10.8 billion). The Bank has accepted securities with a fair value of P11.6 billion (2007: P11.1 billion) as collateral for the securities lent under this programme.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2008

29. GOVERNMENT OF BOTSWANA BONDS

In accordance with Sections 56 and 57 of the Bank of Botswana Act (CAP 55:01), the Bank acts as agent of the Government for the issuance and management of the Government Bonds and Treasury Bills. An analysis of the bonds issued is provided below:

Government of Botswana Bonds and Treasury Bills issued as at December 31, 2008

Bond Detail		BW 003	BW 004	BW 005	BW 110309	
Date of Issue		May 6, Nov 3 , 2003 and Sept 10, 2008	Mar 12 and Sept 10, 2008	Mar 12 and Sept 10, 2008	Sept 10, 2008	
Date of Maturity		Oct 31, 2015	Mar 12, 2011	Sept 12, 2018	Mar 11, 2009	Total
Interest Rate (per annum)		10.25 percent	10.50 percent	10.00 percent	12.25 percent	P'000
Nominal Value	(P'000)	1 050 000	600 000	650 000	300 000	2 600 000
Net (Discount)/Premium	(P'000)	(26 679)	1 515	5 699	(16 803)	(36 268)
Net Proceeds	(P'000)	1 023 321	601 515	655 699	283 197	2 563 732
Interest Paid to date	(P'000)	494 563	26 250	25 000	-	545 813
Interest Accrued	(P'000)	18 433	19 318	19 931	11 193	68 875

(i) Net proceeds realised from the issue of the bonds were invested in the Government Investment Account.

(ii) Interest is payable on all bonds on a semi-annual basis in arrears. During the year to December 31, 2008 total interest payments of P210 485 000 were made (2007 – P179 375 000) and were funded from the Government's current account maintained with the Bank.

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS

Risk is inherent in the Bank's management of financial instruments which are comprised primarily of foreign exchange reserves, which are held in various financial instruments. This risk is managed through a process of ongoing identification, measurement and monitoring that is subject to an extensive framework of risk limits and other controls. The process of risk management is critical to the Bank's ongoing operations, with the day to day management of the financial instruments being conducted by the Financial Markets Department. A key element in the risk management of the foreign exchange reserves is safety, defined as the preservation of purchasing power of the foreign exchange reserves. To this end, the Bank has continued to pursue a conservative and diversified investment strategy, with an SDR weighted currency allocation as the benchmark. The Bank's objectives, policies and procedures for managing the risk exposures and the method used to measure the risks have remained consistent with the prior year. However, the global financial crisis in 2008 posed a challenge to the risk management framework through credit downgrades and steep decline in global equity prices. The Bank's overall framework has served the Bank well through the challenging times and through strict adherence to objectives and policies. The risk management framework remains sound and effective.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2008

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)

Risk Management Governance Structure

The Bank's risk management governance structure is broadly as follows:

(i) Board

The Board is responsible for the Bank's overall risk management and for approving investment policies and guidelines. The Bank's management reviews the risk management policies from time to time.

(ii) Investment Committee

The Investment Committee, which is chaired by the Governor and comprises representatives from relevant areas of the Bank, meets regularly to review developments in the international financial and capital markets. Where necessary, the Investment Committee makes decisions on Bank managed portfolios. The Investment Committee also monitors the performance of the external fund managers.

(iii) Financial Markets Department

The Financial Markets Department is responsible for the management of the foreign exchange reserves and has a specialised Risk Management Unit focusing on the risks associated with all the investment portfolios and ensures compliance with investment guidelines.

(iv) Segregation of Duties

At an operational level, the main feature of risk control is the segregation of duties relating to dealing, settlement, risk monitoring and recording. These responsibilities are split among three Departments: Financial Markets, Payments and Settlement and Accounting and Planning.

Tranching of Foreign Exchange Reserves – Liquidity Portfolio and Pula Fund

The Bank of Botswana Act (CAP 55:01) requires the Bank to maintain a primary international reserve, that is, the Liquidity Portfolio, while Section 35 provides for the establishment and maintenance of a long-term investment fund, the Pula Fund. In compliance with the statutory requirements, a major feature of the foreign exchange reserves management strategy is, therefore, to allocate a certain level of reserves to the Liquidity Portfolio, with the remaining amount invested in the Pula Fund.

Pula Fund

Investments of the Pula Fund comprise long-term assets, such as long-dated bonds and equities actively traded in liquid markets, with the expectation of earning a higher return than could be achieved on conventionally managed investments. The asset allocation between bonds and equities is determined using a combination of historical data and assumptions. Exercises are also conducted in respect of the Pula Fund risk/return sensitivity analysis, using different portfolio options, where risk is measured by a standard deviation on the rate of return.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2008

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)

Liquidity Portfolio

In terms of the investment guidelines, the Liquidity Portfolio gives priority to liquidity over return given the constant need to provide foreign exchange to finance transaction payments. While the eligible investment currencies are similar to those of the Pula Fund, the Liquidity Portfolio is largely invested in the Bank's transaction currencies.

There are no equities in the Liquidity Portfolio and investment instruments include government bonds of eligible grade currencies issued by AAA–rated supranational and AAA–rated US agencies in eligible currencies; other liquid money market instruments are also eligible.

Types of Risk Exposure

The Bank's investment guidelines cover basic types of risk exposures, namely, market risk (currency risk, interest rate risk and equity price risk), credit risk, liquidity and instrument risk. These types of risk apply to both the Pula Fund and the Liquidity Portfolio, but vary in terms of interest rate risk and credit risk.

(i) Currency Risk

The foreign exchange reserves are invested in currencies that are freely convertible, less susceptible to frequent and sharp exchange rate fluctuations and are used in well developed financial markets. The Bank's policy is to invest only in currencies with high ratings assigned by Moody's Investors Services and Standard and Poor's. Through a diversified currency allocation relative to an SDR weighted benchmark, the Bank ensures that the purchasing power of the foreign exchange reserves is preserved. In terms of the Investment Guidelines, a maximum deviation from the neutral level (using the SDR weights as a benchmark) for USD and EUR of 10 percentage points is permitted, while a deviation of up to 5 percentage points on all other currencies is permitted. At the end of 2008, the Bank's total exposure to SDR and related currencies was P66.1 billion (2007: P56 billion).

(ii) Interest Rate Risk

Interest rate risk is the possible loss in the value of a fixed income asset resulting from an unexpected and adverse movement in interest rates and a consequent change in price. Interest rate risk is measured by modified duration, which measures the sensitivity of the price of a bond to changes in interest rates expressed in years. The Bank benchmarks the interest rate risk for the Pula Fund (fixed income assets) to reflect the long-term nature of the portfolio with emphasis on higher return. The higher interest rate risk is generally compensated by higher returns expected from longer maturity bonds. The modified duration benchmark will vary over time, as changing market conditions and index weights impact the global modified duration of the index. At the end of 2008, the average modified duration of the fixed income portion of the Pula Fund was 6.4 years (2007: 5.7 years). As the Liquidity Portfolio gives priority to liquidity over return, given the constant need to provide foreign exchange to finance transaction payments, from the Bank's perspective, this portfolio is exposed to minimum interest rate risk. At the end of 2008, the Liquidity Portfolio's average modified duration was 1.5 years (2007 : 1.5 years).

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2008

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)

Types of Risk Exposure (Continued)

(iii) Equity Price Risk

Equity price risk is the risk that the value of equities decreases as a result of changes in the level of equity indices and diminution of value of individual stocks. The geographic allocation of equity exposure follows generally the market capitalisation among the major markets. The investment guidelines stipulate the holding levels of equities. Holdings of more than 5 percent in one company are not permitted. A reasonable spread among the industry sectors is maintained in the portfolio. There are no investments in private placements or unquoted stocks. At the end of 2008, the equity portion of the Pula Fund was P8.3 billion (2007: P11.1 billion). The decline in global equity prices has caused the value of equities in the Pula Fund to fall.

Market Risk Sensitivity Analysis

The set of assumptions used for each of the risk factors hereunder are not forecasts, but merely "what if" scenarios and the likely impact on the current portfolio, based on selected changes in risk variables over a one year horizon.

The Table below gives an indication of the risk sensitivities of the portfolio to various risk parameters. Assuming that the probability of the beneficial change in the risk variables are as likely to happen as an adverse change, both potential increase and decrease are shown for the indicated scenarios.

December 31, 2008

Risk Variable		Adverse market change			Beneficial market change		
		Scenario	Effect on income statement (P'000)	Effect on equity (P' 000)	Scenario	Effect on income statement (P '000)	Effect on equity (P' 000)
Interest Rate Risk		Increase in yields by 50 basis points	(35 108)	(1 319 391)	Decrease in yields by 50 basis points	35 108	1 319 391
Currency Risk	SDR currencies	Strengthening of the Pula by 1%	(578 338)	(83 060)	Weakening of the Pula by 1%	578 338	83 060
	South African rand	Strengthening of the Pula by 1%	(24 719)	–	Weakening of the Pula by 1%	24 719	–
Equity Risk	Global Equities	Decline in global equity prices by 5%	–	(415 298)	Increase in global equity prices by 5%	–	415 298

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2008

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)

December 31, 2007

Risk Variable		Adverse market change			Beneficial market change		
		Scenario	Effect on income statement (P'000)	Effect on equity (P' 000)	Scenario	Effect on income statement (P '000)	Effect on equity (P' 000)
Interest Rate Risk		Increase in yields by 50 basis points	(20 450)	(719 361)	Decrease in yields by 50 basis points	20 450	719 361
Currency Risk	SDR currencies	Strengthening of the Pula by 1%	(448 205)	(111 480)	Weakening of the Pula by 1%	448 205	111 480
	South African rand	Strengthening of the Pula by 1%	(25 499)	–	Weakening of the Pula by 1%	25 499	–
Equity Risk	Global Equities	Decline in global equity prices by 5%	–	(557 402)	Increase in global equity prices by 5%	–	557 402

The market risk estimates as presented in the Table above are based on sensitivities to the individual risk factors. The correlation between the risk variables is not reflected in the effects on the income statement and equity.

(iv) Credit risk

This is the risk that would arise if an entity that the Bank conducts business with is unable to meet its financial obligations or in the event of an adverse credit event or default. This may be a commercial bank accepting a deposit, a sovereign, supranational or corporate entity issuing a bond or a counterparty with whom the market participant has contracted to buy or sell foreign exchange or money or capital market instruments. In the Bank's endeavour to control credit risk, it deals with only the best quality institutions or counterparties, as determined by international rating agencies.
Consistent with the Investment Guidelines, the Bank withdraws the invested funds if there has been a downgrade of any institution. In cases where the new lower rating necessitates a lower exposure, funds are withdrawn to ensure that the new limit is not exceeded. As a consequence of downgrades in 2008 more funds are placed with lower rated banks, but still within the existing credit limits.

The Bank mitigates credit risk by addressing the following underlying issues:

- Defining eligible investment instruments;
- Pre-qualifying counterparties (financial institutions, brokers/dealers, and intermediaries) doing business with the Bank; and
- Diversifying investment portfolios so as to minimise potential losses from securities or individual issuers.

The Bank has not impaired any of its assets in the current and previous period.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2008

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)

Exposure to Credit Risk

The Table below shows the maximum exposure to credit risk for the components of the balance sheet, including derivatives. The maximum exposure is shown gross, before the effect of the above mitigation factors.

	Notes	2008 P'000	2007 P'000
Foreign Exchange Reserves			
Liquidity Portfolio			
Bonds – held for trading		4 835 556	2 825 919
Cash and cash equivalents	2.1	11 522 628	15 563 297
Pula Fund			
Bonds – available-for-sale		41 371 065	25 387 681
Derivative financial instruments – held for trading		2 344	12 396
Cash and cash equivalents	2.2	1 973 916	3 181 244
International Monetary Fund-loans and receivables			
Reserve tranche	3.1	97 891	41 832
Holdings of Special Drawing Rights	3.2	457 728	365 366
Administered Funds	3.4	71 814	–
Government of Botswana Bonds – available-for-sale	4	41 019	89 045
Other Assets-staff loans and advances – loans and receivables	5	73 368	62 626
Total		60 447 329	47 529 406
Analysis of Credit Exposure by class:			
Measured at fair value			
Bonds		46 206 621	28 213 600
Derivatives		2 344	12 396
Government of Botswana Bonds		41 019	89 045
Measured at amortised cost			
IMF Reserves		627 433	407 198
Staff advances		73 368	62 626
Other		13 496 544	18 744 541
Total		60 447 329	47 529 406

While financial instruments are recorded at fair value, the amounts shown above represent the current credit risk exposure, but not the maximum risk exposure that could arise in future as a result of changes in values.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2008

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)

The Tables below reflect the credit exposure based on the fair value of the assets with counterparties as at December 31, 2008.

Credit Exposure on Bonds

Moodys/S&P Rating	Government (P'000)	Corporate (P'000)	Other (P'000)	2008 Total (P'000)	2007 Total (P'000)
Aaa/AAA	36 784 989	2 129 678	16 689	38 931 356	21 917 749
Aa1/AA+	1 813 493	252 458	–	2 065 951	901 321
Aa2/AA	3 565 270	461 609	–	4 026 879	2 125 695
Other	1 035 746	134 613	12 076	1 182 435	3 268 835
Total	43 199 498	2 978 358	28 765	46 206 621	28 213 600

Credit Exposure to Commercial Bank Deposits (Cash and Cash Equivalents)

Fitch/IBCA Rating	2008 (P'000)	2007 (P'000)
A1	7 626 616	14 210 089
A2	–	562 337
A/B1	104 617	1 974 737
A/B2	669 845	61 151
A/B4	841 018	
B1	2 851 861	1 815 362
B2	–	119 825
B/C1	166 212	–
B/C2	413 378	–
Other	822 997[1]	1 041
Total	13 496 544	18 744 541

Credit Exposure on Securities Lending Programme

The Bank's global custodian manages a securities lending programme as agent of the Bank. Due to the short term nature of the securities lending transactions the collateral received under this programme changes on a short term basis. The securities lending is regulated by a securities lending agreement with the global custodian and follows the general criteria for the Bank's credit exposure. The global custodian monitors the market value of the collateral and where necessary, obtains additional collateral in line with the underlying agreement.

(v) Instrument Risk

Sovereign Bonds

In accordance with the investment guidelines, the Bank invests in eligible instruments that are direct obligations or obligations explicitly guaranteed by governments or local governments of 11 selected sovereign countries that are highly rated by Standard and Poor's and Moody's Investors Services. Exposure limits are assigned to the specific sovereign countries in accordance with the ratings assigned by the credit rating agencies.

1. The figure represents pending trades, derivatives and other receivables.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2008

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)

Corporate Bonds

The Bank invests in a small proportion of corporate bonds rated Aa2/AA or higher, with the issuer being incorporated and tax resident in a country whose sovereign debt is eligible for investment by the Bank. A reasonable geographical spread of issuers is maintained.

(vi) Liquidity risk

Liquidity risk is the risk that the Bank will be unable to meet its payment obligations when they fall due, hence liquidity is an integral part of the Bank's foreign exchange policy. To limit this risk, management manages the assets with liquidity in mind and monitors future cash flows and liquidity on a daily basis. The Bank is exposed to daily Pula liquidity requirements on the deposits it holds on behalf of the shareholder, Government of Botswana, the banking system and other clients holding deposits with the Bank (mainly parastatals). For the purpose of managing foreign exchange reserves, the Bank keeps some of its assets in cash, call deposits and other liquid money market instruments to enable the availability of liquidity to meet outflows without incurring undue capital loss and to provide flexibility to respond effectively to changing market requirements.

Financial Liabilities at Undiscounted Cash Flows

The Table below summarises the maturity profile of the Bank's financial liabilities as at December 31, 2008 based on contractual undiscounted repayments obligations.

December 31, 2008	Less than 3 months (P000)	3-12 months (P'000)	1-5 years (P'000)	Over 5 years (P'000)	Total (P'000)
Bank of Botswana Certificates	17 642 140	–	–	–	17 642 140
Deposits	3 065 303	–	–	–	3 065 303
Allocation of SDR-IMF	–	–	–	50 756	50 756
Liabilities to Government-IMF	–	–	–	97 891	97 891
Dividend to Government	325 500	–	–	–	325 500
Other Liabilities	56 778	–	–	–	56 778
Total	21 089 721	–	–	148 647	21 238 368

December 31, 2007	Less than 3 months (P'000)	3-12 months (P'000)	1-5 years (P'000)	Over 5 years (P'000)	Total (P'000)
Bank of Botswana Certificates	13 968 280	2 910 540	–	–	16 878 820
Deposits	2 383 694	–	–	–	2 383 694
Allocation of SDR-IMF	–	–	–	41 594	41 594
Liabilities to Government-IMF	–	–	–	41 832	41 832
Dividend to Government	226 500	–	–	–	226 500
Other Liabilities	61 676	–	–	–	61 676
Total	16 640 150	2 910 540	–	83 426	19 634 116

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2008

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)

Other Risks

(vii) External Fund Managers

External fund managers are engaged to complement the Bank's reserve management activity. The fund managers are approved by the Board.

(viii) Custody

The Bank uses the services of a custodian which provides custodial services for the Bank's assets and ensures that the transactions executed by fund managers are settled in a timely manner, consistent with international best practice.

(ix) Operational Risk

Operational risk is the risk of loss arising from systems failure, human error, fraud or external events. When controls fail to perform, operational risks can cause damage to reputation, have legal or regulatory implications or lead to financial loss. The Bank cannot expect to eliminate all operational risks, but through a control framework and by monitoring and responding to potential risks, the Bank is able to manage the risks.

31. RELATED PARTY BALANCES AND TRANSACTIONS

Balances and Transactions with the Government

The Bank provides several services to its shareholder, the Government. The main services during the year to December 31, 2008, were:

(i) provision of banking services, including holding of the principal accounts of the Government;

(ii) management of the Notes and Coin in issue, including printing and minting of notes and coin; and

(iii) being the Government agent for government bonds and treasury bills

The aggregate balances in Government accounts are disclosed in Notes 8 to 10.

No charge is made to the Government for provision of these services, except for commissions charged in domestic foreign exchange transactions, which are included in "Profit on domestic foreign exchange deals" in the Income Statement. This amounted to P176 340 000 (2007: P201 124 000).

The Bank earned interest on its holding of the Government of Botswana Bonds (as described in Note 4) of P5 814 000 (2007: P8 829 000).

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2008

31. RELATED PARTY BALANCES AND TRANSACTIONS (Continued)

Other Related Party Balances and Transactions

(i) Debswana Diamond Company (Proprietary) Limited, a company partly owned by the Government, holds a special Debswana Tax Holding Account at the Bank to facilitate payment of the company's tax obligations to the Government. Interest is payable on the daily account balance, at the rate of 60 basis points below the prevailing BoBCs three month rate. The interest expense paid in this regard is reflected in Note 22. This account was closed during the year.

(ii) Purchases of air tickets amounting to P390 000 (2007: P410 000) were made from Air Botswana, an institution wholly owned by the Government. These were charged to Administration costs in the Income Statement.

(iii) Amounts due to related parties.

Included in the balance of outstanding "Deposits – Other" in Note 8 are the following balances with Government-owned or partly owned institutions.

	2008 P'000	2007 P'000
Botswana Development Corporation	–	6
Botswana Savings Bank	5 611	2 117
Botswana Unified Revenue Service	188 464	70 918
Debswana Diamond Company (Proprietary) Limited	–	18 223
Total	194 075	91 264

The amounts outstanding are unsecured and have no fixed repayment terms.

(v) Remuneration of Key Management Personnel

Key management personnel comprise the Governor, Board Members, Deputy Governors and Heads of Department.

Gross emoluments of the key management personnel are:

	2008 P'000	2007 P'000
Non-Executive Board members	116	104
Executive Management		
Short term benefits	7 027	5 601
Post-employment benefits	428	381
Other long-term employee benefits	738	609
	8 309	6 695

Of the Staff Loans and Advances per Note 5, P2 383 000 (2007: P2 912 000) are attributable to Executive Management.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (CONTINUED)

DECEMBER 31, 2008

32. POST BALANCE SHEET EVENTS

Subsequent to the year end, as a result of the volatility in the global financial markets, the following gains and losses on foreign exchange reserves have been recognised by the Bank, measured at January 31, 2009.

	Pula Fund P'000	Liquidity Portfolio P'000
Realised foreign exchange gains	350 280	51 112
Realised market (losses)/gains	(76 714)	6 635
Unrealised foreign exchange gains	2 040 337	465 606
Unrealised market losses	(1 799 993)	(18 859)

PART B

THE BOTSWANA ECONOMY IN 2008 AND THEME CHAPTER

BANK OF BOTSWANA

CHAPTER 1
THE BOTSWANA ECONOMY IN 2008

1. OUTPUT, EMPLOYMENT AND PRICES

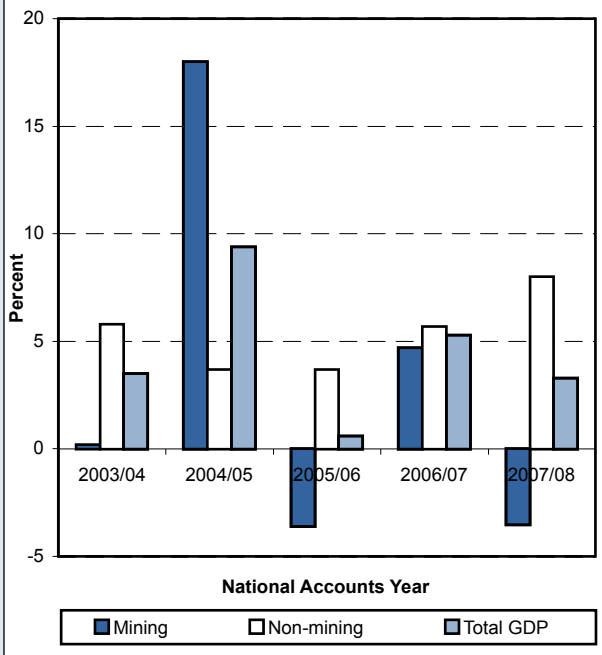
(a) National Income Accounts

Overview

1.1 For 2007/08,[1] provisional figures indicate a moderation of growth in the economy, with real gross domestic product (GDP) growing at 3.3 percent, compared to 5.3 percent in 2006/07. The slower growth, in the main, reflects a contraction in mining output, even before the impact of the global economic slowdown in the second half of 2008. As a result of reduced growth in 2007/08, average growth in the first five years of National Development Plan 9 (NDP 9) was 4.4 percent, compared to 5.5 percent previously anticipated over the course of the plan period. NDP 10 was due to commence in 2009[2] and, as highlighted in the 2009 Budget Speech, average annual growth of 7.5 percent per annum will be required over the next seven years to meet the targets of *Vision 2016*, to which NDP 10 is aligned. The prospects for attaining such rapid and sustained growth are considered further below.

1.2 As indicated in Chart 1.1, in 2007/08 the mining sector contracted by 3.5 percent, after growing by 4.7 percent the previous year. In contrast, non-mining sectors performed well overall with average growth rising from 5.7 percent to 8 percent. Preliminary estimates

CHART 1.1: REAL GDP GROWTH DURING NDP 9



Source: Central Statistics Office.

indicate that this trend of a mining slowdown, being countered by buoyant growth in other sectors, continued into the first quarter of 2008/09, with year-on-year non-mining growth at 7.4 percent.

Performance by Economic Sector

1.3 Chart 1.2 shows sectoral growth rates for 2006/07 and 2007/08 (see also Table 1.1 which, in addition, includes the original estimates for 2006/07, indicating the extent of subsequent revisions, and average growth in the first four years of NDP 9), while Chart 1.3 compares sectoral contributions to growth in 2007/08 with the first four years of NDP 9. The slowdown in mining activity in 2007/08 was not generally attributable to the onset of recession in the major economies. Rather, the fall in production was due to the major diamond mines in Botswana having reached maturity, with other sources of additional output still being developed. Through most of 2008, the mining industry was subject to

1 Until 2008, the national accounts year ran from July to June. However, from 2009 the estimates will be prepared on a calendar year basis to facilitate comparison with other annual economic data. The presentation of relevant tables in Bank of Botswana publications will also be adjusted accordingly.

2 NDP 10 was originally scheduled to commence in April 2009, at the beginning of the 2009/10 financial year. However, submission of the Plan to Parliament has been delayed so as to allow it to be re-evaluated in the light of the global economic downturn.

TABLE 1.1: GDP GROWTH BY MAJOR ECONOMIC SECTOR, 2003/04 – 2007/8 (PERCENT)

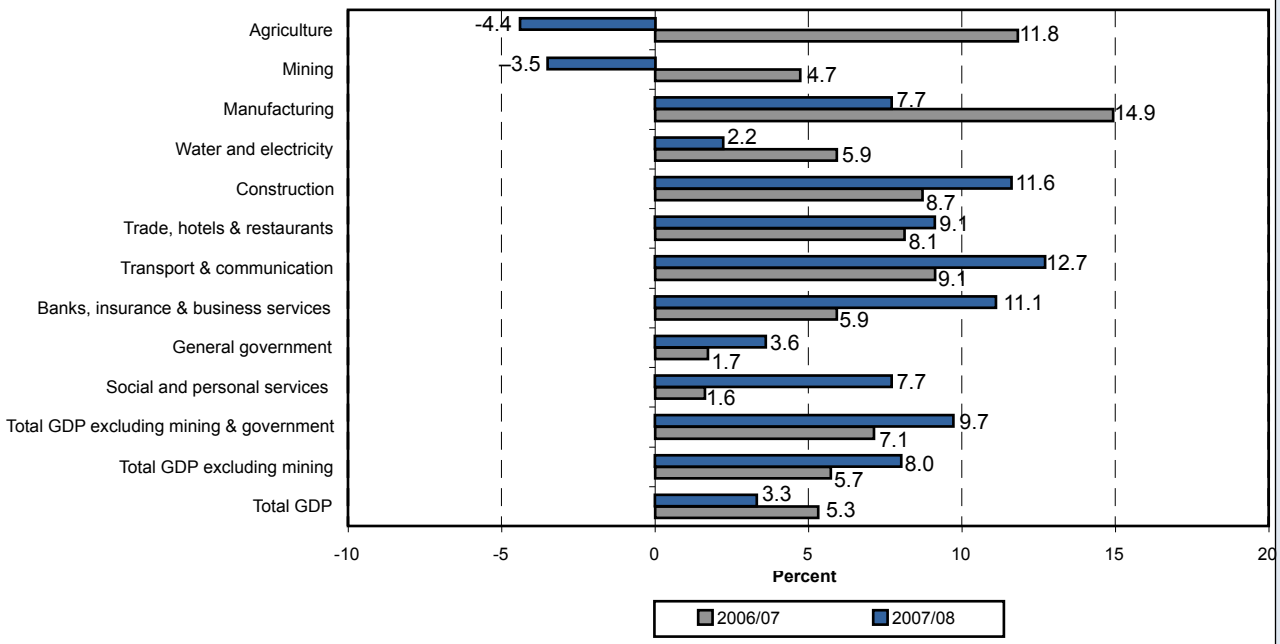
	2007/08 (prelim)	2006/07 (revised)	2006/07 (prelim)	2003/04 – 2006/07 (average)
Agriculture	–4.4	11.8	2.9	0.0
Mining	–3.5	4.7	5.2	4.8
Manufacturing	7.7	14.9	12.0	6.5
Water & electricity	2.2	5.9	5.9	4.8
Construction	11.6	8.7	8.7	2.1
Trade, hotels and restaurants.	9.1	8.1	16.3	4.4
Transport & communication	12.7	9.1	20.3	7.6
Banks, insurance & business services	11.1	5.9	6.6	6.0
General government	3.6	1.7	1.7	3.9
Social & personal services	7.7	1.6	1.6	6.6
Total GDP	3.3	5.3	6.2	4.7
Excluding mining	8.0	5.7	6.8	4.7
Excluding mining & government	9.7	7.1	8.8	5.0

Source: Central Statistics Office.

supply shortages rather than shortfalls in demand, with escalating costs among the principal reasons for both the cancellation of the Botswana Metal Refinery project and the scaling down of the proposed mine and power station development on the Mmamabula coal field. However, weaker demand for commodities, principally diamonds, but also for copper and nickel,[3] is expected to be reflected in weaker economic data for the final quarter of 2008.

1.4 As is evident from Chart 1.2, the growth of non-mining sectors in 2007/08 was led by *transport and communications* (12.7 percent), *construction* (11.6 percent), *banks, insurance and business services* (11.1 percent) and *trade, hotels and restaurants* (9.1 percent). With *general government* increasing by only 3.6

CHART 1.2: GDP GROWTH 2006/07 – 2007/08



Source: Central Statistics Office.

3 In contrast, demand for gold, which investors continue to regard as safe investment at times of economic turbulence, has remained strong.

percent, growth excluding both mining and government was 9.7 percent. However, rapid expansion in government spending supported growth in other sectors, in particular, the impact of development spending on construction activity.

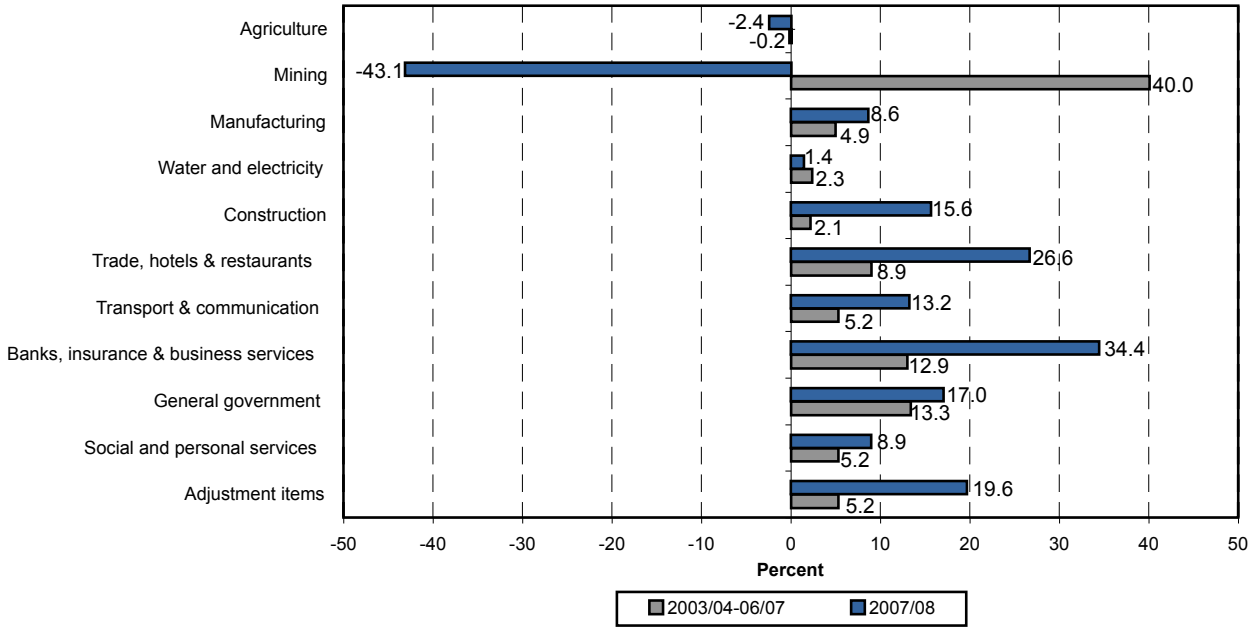
1.5 Apart from mining, only *agriculture* (-4.4 percent), *manufacturing* (7.7 percent) and *water and electricity* (2.2 percent) grew more slowly than in the previous year. The agricultural sector, where output continues to be undermined by slow improvement of farming technologies and practices, was adversely affected by variable rainfall and outbreaks of disease. Output of the electricity sub-sector was constrained by supply shortages which resulted in extensive power cuts during 2008; however, for manufacturing, although down from the previous year, overall growth remained robust.

1.6 In terms of contribution to growth,[4] while mining contributed 40 percent to overall growth between 2003/04 and 2006/07, in 2007/08 this was reversed with a contribution of –43.1 percent. Indicative of some success in economic diversification, the contribution of private sector services to growth has been increasing, while agriculture continues to make only a marginal (and generally negative) contribution to economic growth (Chart 1.3).

(b) Domestic Economic Outlook

1.7 The outlook for the domestic economy must be considered against the backdrop of the unfolding global economic crisis, the extent of which worsened significantly in the last quarter of 2008 (see Box 1.1). As a result, with many economies already in recession,[5] the world economy faces a protracted period of low growth. Any recovery is not expected until 2010 at the earliest, and the prospects of this are heavily dependent on policy responses in the major economies being effective in terms of both supporting demand and restoring confidence and the proper functioning of the banking system.

CHART 1.3: CONTRIBUTION TO GDP GROWTH BY SECTOR 2003/04 – 2007/08



Source: Central Statistics Office.

4 That is, the change in sectoral GDP as a proportion of overall GDP growth.

5 The standard definition of a recession is when an economy experiences negative GDP growth for at least two successive quarters.

1.8 For Botswana, the effect of the crisis is mostly felt through the mining industry. This sector contributes about 40 percent of GDP, such that the anticipated contraction of mining output in 2009 will have a significant negative impact on overall growth.[6] There was virtually no diamond production in the first quarter of 2009, and some of the mines will remain closed for the remainder of the year. This is likely to feed through to other local producers, both upstream suppliers and downstream consumers of mining output, including the infant domestic diamond cutting and polishing industry and associated services. Even if there is some recovery in global growth in 2010, there may be a further lag before this feeds through to a resumption of demand for rough diamonds, given that diamonds are luxury goods. In addition, ready access to bank credit, which has been severely curtailed by the global credit crunch, is crucial to the smooth operation of the diamond supply chain. However, the long-term fundamentals in the diamond industry remain strong with supply constraints rather than deficient demand being the main challenge.

1.9 Demand for textile products and tourist arrivals are also likely to soften, due to slower consumer spending in export markets, while, to the extent that other local industries depend on demand in the regional economy, the slowing of the South African economy (where GDP contracted more than expected, at an annualised rate of 1.8 percent in the fourth quarter of 2008) will have a further negative impact. Nevertheless, the key factor will be the extent to which domestic demand can be supported through an appropriate combination of fiscal and monetary policies (Sections 2 and 4 below). The biannual Business Expectations Survey (BES), conducted by the Bank of Botswana, indicated that during 2008 levels of business confidence remained generally high. The surveys were conducted prior to the magnitude of the global slowdown becoming more apparent and the first BES in 2009 (to be conducted in March and April) may show some decline in confidence. However, this could change if policy is viewed as being supportive of growth.

1.10 The role of fiscal policy is particularly relevant in the case of Botswana, given that government expenditure remains the main linkage between the mining sector and the rest of the economy. During 2008, accelerated implementation of the Government development programme, including the commencement of major infrastructure investments, supported growth, and this is expected to continue in the medium term, even if some lower-priority spending programmes need to be re-considered. Additional private investment, including developments in preparation of the 2010 FIFA World Cup to be held in South Africa, as well as the coal and gas based power supply projects to alleviate regional shortages, will also boost the economy. Indeed, the prospects for some of these investments may be enhanced, given the extent to which the slowdown in mining has eased shortages, including for skilled labour, capital equipment and other inputs. For example, the reduction in mining activity should alleviate the problems of insufficient electricity supply, thus reducing the need for power cuts in other sectors.

(c) Employment[7]

1.11 Estimates for March 2008 indicate that formal sector employment grew by 2.2 percent compared to the same period in 2007, bringing the total number employed (excluding small businesses with less than five employees) in the formal sector by the government, private

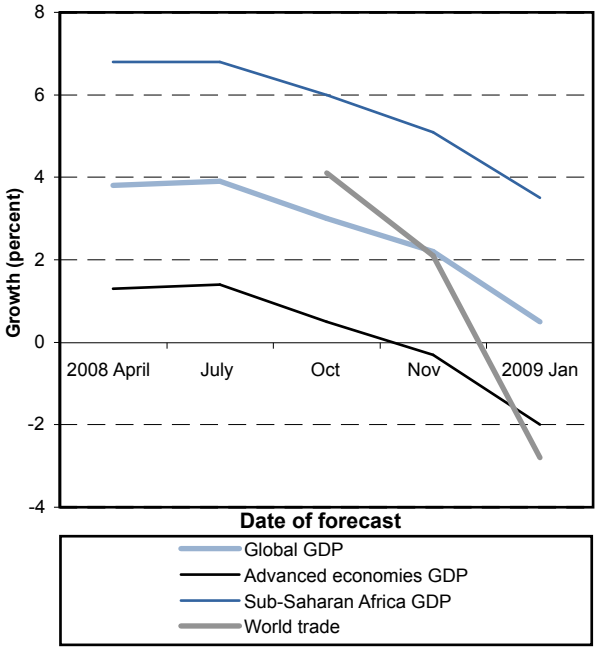
6 A 10 percent contraction in mining output would require the rest of the economy to grow at almost 7 percent for overall GDP not to fall. A fall of at least this magnitude in 2009, and probably considerably more, is all but certain, as production at the diamond mines operated by Debswana was not due to re-commence after an extended shutdown until mid-April, and even then will do so only on a limited basis until demand for rough diamond starts to rise again.

7 The figures cited here differ from those that are published in the *Stats Brief* by the Central Statistics Office (CSO), which have subsequently been revised.

BOX 1.1: THE GLOBAL ECONOMIC CRISIS AND THE IMPACT ON BOTSWANA

Towards the end of 2008 it became clear that Botswana would not avoid the fallout from the global credit crunch and the resulting worldwide economic slowdown. The twin crises had steadily worsened since September, when the global financial system came perilously close to collapse. The collapse of the investment bank, Lehman Brothers, on September 15, 2008 is widely regarded as the start of the latest increasingly severe phase of the global crisis. As indicated in Box Chart 1.1, economic forecasts steadily worsened so that by January 2009, the IMF was forecasting negative growth in all major advanced industrial economies and global GDP growth for the year of only 0.5 percent.[1] While this was driven by a worsening recession in advanced economies, where growth in 2009 is expected to average –2 percent, the impact is being felt globally, as demand for developing countries' exports shrinks rapidly. For sub-Saharan Africa, the outlook for growth in 2009 has deteriorated from the 6.8 percent forecast in July 2008 to 3.5 percent in the latest projections. For the first time since the early 1980s, the volume of global trade is expected to contract.

BOX CHART 1.1: THE DETERIORATING GLOBAL ECONOMIC OUTLOOK: IMF FORECASTS FOR GDP GROWTH AND TRADE IN 2009



Source: International Monetary Fund.

Economic crises have been, and will continue to be, a regular feature of the global economy, the result of corrections to excesses and imbalances that inevitably emerge within a system that encourages innovation and dynamic economic development. However, the current slowdown is of particular severity and is widely regarded as the worst since the Great Depression of the 1930s. Although its start can be traced to the widening consequences of problems in the 'sub-prime' mortgage market in the United States of America from August 2007, it can be attributed to three underlying factors:

First: rapid global growth over the past few years had not been balanced. It was accompanied by extremely large deficits in some countries, matched by the accumulation of surpluses of equal magnitude in others. At the point when the deficits became unsustainable, a period of painful adjustment was inevitable.

Second: the financial sectors of several major economies, including both the United States and the United Kingdom, the world's two major financial centres, had accumulated huge concentrations of risk (so-called 'toxic assets') without appreciating either the extent of this or the costs associated with the downside of those risks materialising. This under-pricing of risk was fuelled by a combination of a glut of savings flowing from surplus countries which contributed to low returns on traditional financial instruments, as well as unsustainable demand for borrowing by households. It is now apparent that regulatory oversight in these sections of the markets did not keep pace with rapid financial innovation and, therefore, failed to restrain risk concentration and instill discipline through prudent risk taking behaviour. Similarly, monetary authorities did not take into account the build-up of systemic risks in financial systems and asset price bubbles, notably in the housing market.

Third: the boom in commodity prices, most notably for oil and food, but also more widely, was always likely to put a break on economic expansion.

The magnitude of the resulting slowdown should not be exaggerated. This is to the extent that the cumulative negative impact on global output is not expected to be of the same order of magnitude observed in earlier periods of economic depressions and there is continued optimism that growth may resume by 2010. In contrast, the Great Depression, between 1930 and 1933 lasted longer and the US economy contracted by an estimated 29 percent. However, uncertainty surrounding the speed of any recovery from the current crisis is magnified by two factors. First, historical experience indicates that, if accompanied by a banking crisis, recessions are particularly severe

1. The Fund subsequently indicated that a further downward revision in the forecast was likely, with the next update due in April 2009.

BOX 1.1: THE GLOBAL ECONOMIC CRISIS AND THE IMPACT ON BOTSWANA (Cont'd)

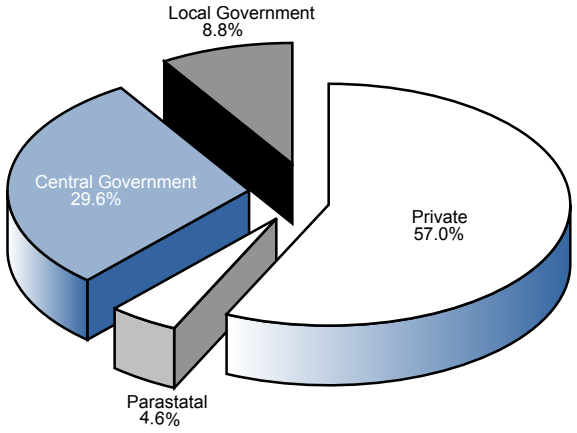
and of long duration.[2] Thus, it is crucial that efforts to restore the smooth functioning of the banking system, which has remained severely impaired, due largely to the uncertainty and continuing erosion of confidence arising from banks' holdings of toxic assets, are successful.

Second, the path of recovery will depend crucially on the response in terms of monetary and fiscal policies which, in turn, requires coordination among major economies. By early 2009, several central banks were operating with interest rates at historic lows, and were considering the use of less conventional instruments of monetary policy including, notably, 'quantitative easing'.[3] Substantial fiscal injections were also being prepared, with much depending on the impact of measures to be introduced in the US, a process that was delayed by change in administrations. However, with the US already in a substantial deficit position, coordination with other countries will be necessary to bring about the required rebalancing of global demand. Coordination will also be required to improve financial regulation and to discourage individual countries from resorting to protectionist measures.

In Botswana, the financial sector remains relatively sound. Lending by local banks has been relatively restrained with deposits far exceeding loans, and positive financial performances have been reported for 2008. However, the adverse effects of the crisis, emanating from reduced demand for exports, such as mining, manufacturing and tourism, with ripple effects to other sectors and resulting increases in unemployment, could result in problems of credit quality for the lenders. The relevant sections of this review focus in more detail on the likely impact on specific sectors, including the balance of payments and foreign exchange reserves, as well as the Government's fiscal policy response.

2. Rogoff, K. and Reinhart, C. (2008) 'The Aftermath of Financial Crises', paper prepared for presentation at the Annual Meeting of the American Economics Association, January 2009.
3. 'Quantitative easing' refers to actions by central banks to expand the monetary base, typically though purchases of government debt or other securities. This is a relevant policy option for monetary authorities when nominal interest rates fall close to zero, leaving little room for further cuts to stimulate demand.

CHART 1.4: FORMAL SECTOR EMPLOYMENT SHARES, MARCH 2008



Source: Central Statistics Office.

sector and parastatals to 309 000. Chart 1.4 shows the distribution of employment across government, parastatals and the private sector as at the end of March 2008. The private sector comprises almost 60 percent of the workforce in formal employment, while the rest are nearly all employed in government.

1.12 Of the increase of 6 600 jobs, 61 percent were in either local or central government, reflecting intensified efforts by government to fill vacancies. Private sector employment increased by 3 000, principally in *manufacturing*, *wholesale and retail trade*, *education,* and *financial services.* Overall, growth in private sector employment was sluggish, at 1.7 percent, although there could be some concerns that the estimates understate the extent of employment creation given that, with the exception of financial services where employment grew by 8.3 percent, the growth rates for the equivalent sectors in the GDP estimates are considerably higher.

1.13 The Central Statistics Office (CSO) has also produced employment estimates for June 2008, with the intention of developing capacity to produce regular quarterly updates. Compared to March, these show only a small increase in formal employment of 0.8 percent to 311 000. Most of the reported increase was in *wholesale and retail trade*, *construction* and *education*.

While the estimates for September 2008 are yet to be released, it is not anticipated that these will show any significant decline in jobs due to the economic crisis which, at that time, had yet to have a significant impact on Botswana.

1.14 During 2008, the CSO also published the preliminary results of the Informal Sector Survey conducted in 2007. Since the previous survey in 1999 the number of informal businesses in Botswana had grown substantially, by 40 percent to over 40 000. Females were predominant in the sector, operating two thirds of informal businesses, which were concentrated in retail and other small-scale services such as hairdressing, while male business operators were found in sub-sectors such as construction. In terms of challenges facing their businesses, most survey respondents cited failure by customers to pay for goods and services obtained on credit, together with stiff competition and lack of capital.

(d) Inflation

1.15 Global economic growth is estimated at a sluggish 3.4 percent in 2008, down from 5.2 percent in 2007.[8] The slowdown in economic activity mainly reflects the impact of significantly higher global energy prices and the resulting tightening of monetary policy in the first half of the year, and the global financial crisis[9] that deteriorated rapidly in the third and fourth quarters of the year. Inflation in advanced economies rose from 2.2 percent in 2007 to 3.5 percent in 2008, driven mainly by rapidly rising food and oil prices. International oil prices rose to a record high of over USD147 per barrel in July, before decreasing sharply to around USD40 in December, as rapidly slowing global growth depressed demand. Meanwhile, the South African target measure of inflation, CPIX,[10] which had remained above that country's target range of 3 – 6 percent since April 2007, rose to 10.3 percent in December 2008 from 8.6 percent the previous year. The acceleration in CPIX inflation, which peaked at 13.6 percent in August, was mainly due to rising food and fuel prices, as well as substantial upward adjustments to domestic electricity tariffs.

1.16 In Botswana, strong domestic demand continued into 2008, adding further to upward pressure on inflation. The annual growth of commercial bank credit to the private sector trended upward for most of the year, while growth in public expenditure was substantially more rapid than had been envisaged in the 2008/09 government budget (although this was in large part a result of overestimated levels of spending in 2007/08; spending in 2008/09 has, in fact, been below budgeted levels). The rapid growth in credit to the private sector and government expenditure contributed to monetary expansion, with M2 (the 'broad money' measure of the money supply) growing by 21.1 percent in 2008 compared to 31.2 percent in 2007.

1.17 The significant monetary expansion largely accommodated the sharp increase in prices, hence headline inflation increased sharply from 8.1 percent in December 2007, peaking at 15.1 percent in August 2008, before falling to 13.7 percent in December. Inflation, therefore, remained well above the upper end of the Bank of Botswana's medium-term inflation objective range of 3 – 6 percent, averaging 12.6 percent in 2008 and significantly higher than the 7.1 percent in 2007. The major sources of upward pressures on inflation were rising costs of food together with increases in administered prices, particularly the cost of fuel which also fed through into increased public transport fares. In response to increases in international oil prices, domestic fuel prices were adjusted upwards in February, April, May, June and July 2008, which cumulatively

8 Figures and projections for global GDP growth and inflation are based on the *World Economic Outlook Update, January 2009* published by the IMF.

9 The on-going global financial crisis, which underlies the recession in industrialised countries, emerged in August 2007 and was triggered by the US sub-prime housing loan crisis.

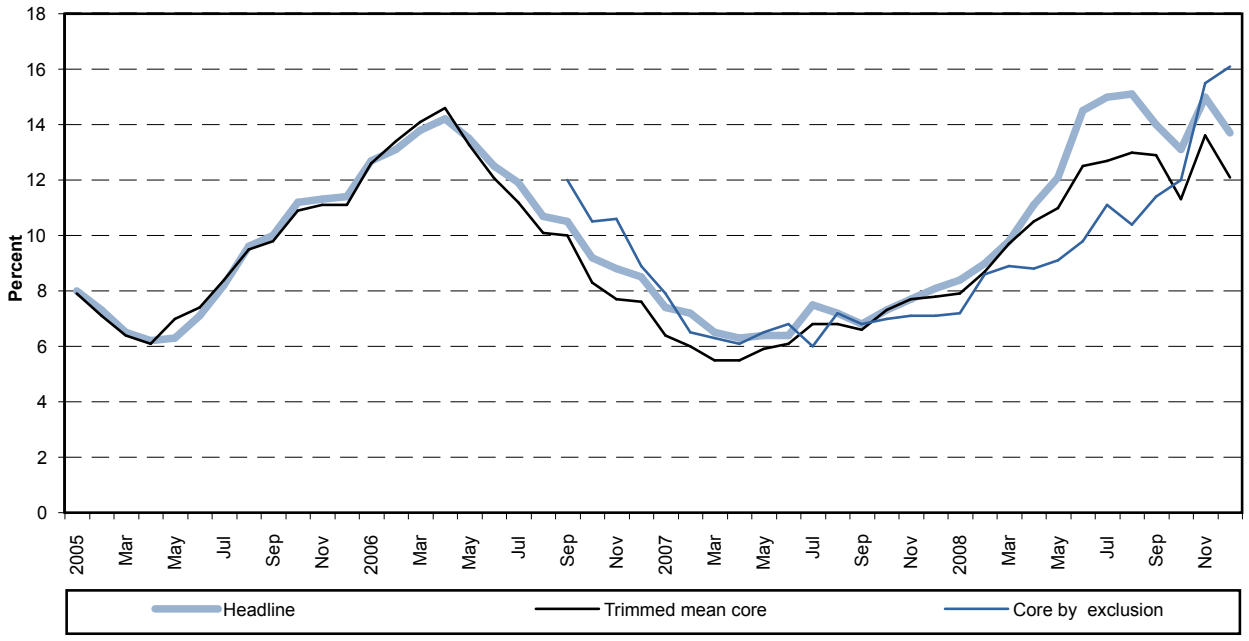
10 CPIX refers to the consumer price index excluding mortgage interest rates. In January 2009, the South African Reserve Bank (SARB) commenced targeting a revised measure of the Consumer Price Index (CPI), which measures housing costs through rentals, and is thus not directly influenced by interest rate movements.

contributed 4.7 percentage points to the national rate of inflation. However, following the reversal of the upward trend in global oil prices, domestic fuel prices were adjusted downwards from August to December, thereby lowering CPI inflation by about 4.2 percentage points by year-end. Although transport fares were raised in June and August, they were reduced in December, mainly in response to the continued decline in fuel prices, and were estimated to have initially lowered inflation by 1.2 percentage points. The increase in electricity tariffs in April contributed marginally to inflation (0.1 percentage points), but the 30 percent levy on alcoholic beverages introduced in November contributed 2.3 percentage points to higher inflation during 2008.

1.18 It is noteworthy that, through much of the first half of 2008, inflation was mainly concentrated in food and fuel prices. For most other commodity groups, the annual rate of price increase remained within or close to (below in some cases) the Bank's 3 – 6 percent inflation objective. This reflected the fact that measured inflation at the time was largely the consequence of a relative price adjustment among goods, rather than a rapid acceleration in overall prices. Subsequently, however, inflation in other commodity groups began to accelerate, indicating the emergence of second-round effects arising from earlier fuel and food price increases.

1.19 The broad-based nature and persistence of inflationary pressures is also apparent from the trends exhibited by measures of core inflation. The trimmed mean measure of core inflation increased during the year to 12.1 percent in December 2008 from 7.8 percent in December 2007, while core inflation excluding administered price items rose from 7.1 percent to 16.1 percent over the same period. The more pronounced increase in the latter measure is due to the exclusion of fuel prices which fell in the latter part of the year and helped moderate overall inflation.

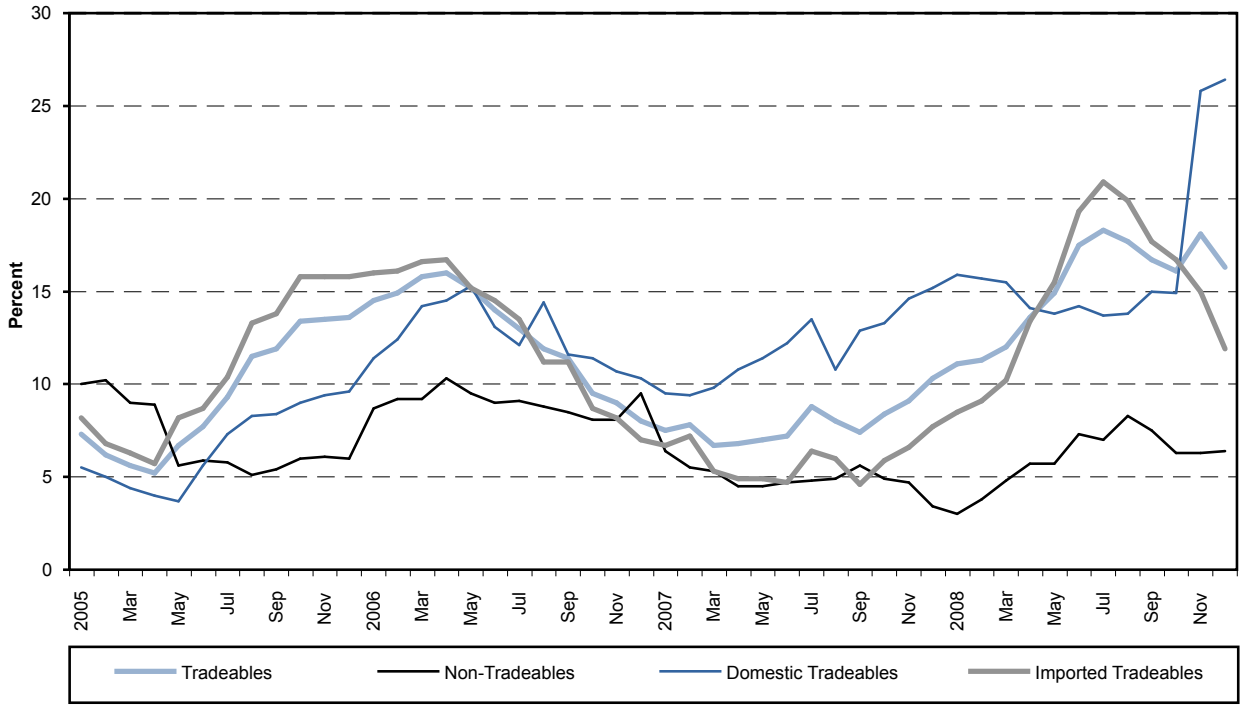
CHART 1.5: HEADLINE AND CORE INFLATION (16 PERCENT TRIMMED MEAN AND BY EXCLUSION), 2005 – 2008



Source: Central Statistics Office.

1.20 Reflecting the impact of rising fuel and food prices, as well as the additional levy on alcohol sales, inflation for tradeable goods and services rose significantly from 10.3

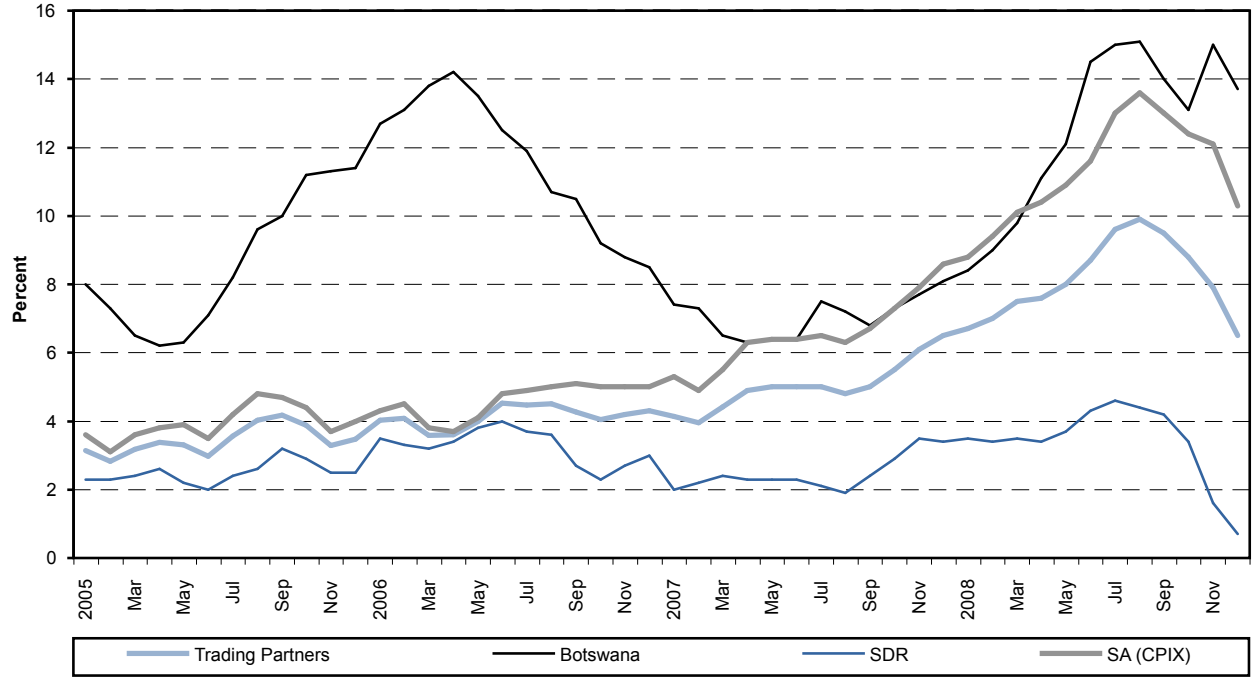
CHART 1.6: TRADEABLE AND NON-TRADEABLE INFLATION, 2005 – 2008



Source: Central Statistics Office.

percent in December 2007 to 16.3 percent in December 2008. For imported tradeables, the increase, from 7.7 percent to 11.9 percent, was relatively subdued, due to the impact of falling fuel prices towards the end of the year. In contrast, domestic tradeables' inflation, which included the impact of the alcohol levy, rose sharply, from 15.2 percent to 26.4 percent. The increase in non-tradeables inflation was moderate, increasing from 3.4 percent to 6.4 percent during the course of the year, although the increases in electricity tariffs and, subsequently, public transport fares had pushed it to 8.3 percent in August.

CHART 1.7: BOTSWANA AND TRADING PARTNER INFLATION, 2005 – 2008



Source: Central Statistics Office and Bank of Botswana.

1.21 In 2009, global economic activity is expected to slow down sharply, with forecast annual GDP expansion at 0.5 percent, compared to 3.4 percent estimated for 2008. This is due to the impact of the global economic slowdown and financial crisis, the effects of which have increasingly spread from the advanced economies to emerging markets. In the context of the increasing economic slack and commodity prices stabilising at lower levels due to weakening world demand, global inflationary pressures are expected to be moderate. Overall, global inflation is forecast to fall to 4.6 percent in 2009 from 6.2 percent in 2008. For the SDR countries (the euro zone, Japan, United Kingdom and USA), average inflation is forecast to fall from 3.6 percent in 2008 to 1.8 percent in 2009.[11] In South Africa, inflation is projected to fall within the target range of 3 – 6 percent by the third quarter of 2009, with an average of 6.9 percent in 2009 compared to 8.1 percent in 2008.

1.22 In Botswana, the principal domestic pressures on inflation had yet to subside by the end of 2008. Annual growth in commercial bank credit remained elevated at year end, although this could be moderated by the absence of a cost of living wage adjustment for the public service in 2009, as well as by job losses due to the economic downturn. Budgeted government spending is also set to grow less rapidly in 2009 compared to 2008; and a proposed spending review could lead to some trimming of the budget. While output growth is expected to be subdued, further upside risks to the inflation outlook arise from possible increases in administered prices, government levies and consumption taxes with a view to catching up with the increase in operating costs and also to facilitate cost recovery for infrastructure development. In particular, Botswana Housing Corporation rentals, which were not increased in 2008, could be increased in 2009. Also, electricity tariffs could be adjusted again if Eskom, the South African power utility, implements a further round of substantial electricity tariff increases in 2009. In contrast, other sources of inflationary pressure can be expected to ease rapidly, especially in the first half of 2009 as the impact of fuel price increases in 2008 gradually drops out of the inflation calculation. Later in the year, a further substantial fall in inflation can be anticipated as the impact of the alcohol levy introduced in November 2008 also dissipates. As a result, by the end of the year, inflation is expected to be much closer to, if not yet within, the upper end of the 3 – 6 percent objective range.

11 Forecast made in October 2008.

2. PUBLIC FINANCE AND THE 2009 BUDGET SPEECH

2.1 The 2009 Budget Speech[12] presented the Government budget proposals for the 2009/10[13] financial year, which is the first year of NDP 10. However, the formal adoption of the new Plan has been delayed until later in 2009 to allow for a reassessment of the draft in order to take proper account of the global economic slowdown that has recently impacted heavily on Botswana. NDP 10 will cover the period April 2009 to March 2016, a year longer than the normal six years for NDPs in Botswana. This is in order for the end of the Plan to coincide with the culmination of *Vision 2016*, which establishes nationally agreed long-term development goals. The theme for the Plan is *"Accelerating Vision 2016 through NDP 10"*. However, objectives of *Vision 2016* for achieving "Prosperity for All" through accelerated economic expansion, diversification and poverty reduction were already at risk through lower-than-targeted growth and are further threatened by the onset of the economic crisis. To allow time to realign the Plan to challenges posed by the crisis, discussion of the draft by Parliament was deferred until later in 2009.

12 Presented by the Minister of Finance and Development Planning to the National Assembly on February 2, 2009.

13 The Government financial year runs from April 1 to March 31.

(a) Budgetary Performance – 2007/08 and 2008/09

(i) 2007/08 Final Budget Outturn

2.2 The final budget outcome for 2007/08 was a surplus of P3.8 billion, which exceeded the surplus of P787 million that was forecast in the revised budget presented at the time of the 2008 Budget Speech. A higher-than-budgeted surplus is a typical outcome of budgets in Botswana that reflects both persistent underspending, particularly of the development budget and, to a lesser extent, additional revenue collections. At P28.6 billion, total receipts were 5.4 percent above the revised estimates, mainly due to increased mineral revenues, which were boosted by higher prices and volumes of diamond sales; in addition, revenue collected by the Botswana Unified Revenue Service (BURS) was increased as a result of improved VAT, together with higher receipts from the Southern African Customs Union (SACU).

2.3 Total expenditure and net lending in 2007/08 stood at P24.8 billion, representing underspending of P1.6 billion (6 percent) compared to the revised budget estimate of P26.4 billion. While recurrent expenditure, at P18.6 billion, comprised three quarters of total spending, the recurrent budget was underspent by only P153 million (0.8 percent). In contrast, development spending of P6.6 billion was 15.2 percent lower than the revised budget of P7.76 billion.

(ii) 2008/09 Revised Budget

2.4 The revised budget for 2008/09 envisages a deficit of P6.1 billion, which is significantly more than the original estimate of a deficit of P0.3 billion. The higher deficit is due to additional spending commitments of P5.7 billion spread across both the recurrent (P1.7 billion) and the development (P4 billion) budgets. The increase in the recurrent allocation does not reflect additional costs of personal emoluments arising from the 15 percent across-the-board salary adjustment and introduction of scarce skills allowances in 2008, as these were mainly absorbed within the existing budget.[14] The additional spending is principally because of the funding requirements of the Ministry of Education and Skills Development for tertiary education bursaries that had exceeded the budget by P915 million. Within the development budget, the main sources of additional spending were the Government's equity contribution of P1.5 billion to the expansion of the Morupule power station; P905 million for the Ministry of Local Government for infrastructure maintenance and the costs of labour intensive public works programmes;[15] and P465 million for the Ministry of Agriculture to fund food security programmes and combating foot and mouth disease, as well as the newly-introduced Integrated Support Programme for Arable Agriculture Development (ISPAAD).

2.5 The revenue budget was revised downwards only slightly, by P209 million, mainly due to a fall in expected receipts for non-mineral income tax by P734 million. The estimate for mineral related revenues was revised up by P302 million, despite the onset of the global slowdown that severely undermined diamond sales from November 2008. To some extent, this may be due to lags in the budgeting process, with the revised estimates being prepared before the extent of the downturn in diamond sales was apparent. But it should also be noted that there is some degree of cushioning within the estimate due to the buoyancy of sales earlier in the year, when both the volume of sales and prices for rough diamonds exceeded expectations and domestic currency receipts were boosted by the depreciation of the Pula against the US dollar.

2.6 Nevertheless, there appears to be a serious risk that mineral revenues will fall short of the budget: they were negligible in the final quarter

14 This is with the exception of the Ministry of Local Government, which required an additional P191 million to meet the cost of additional salaries.

15 These have now been made a permanent feature for all local authorities, replacing the irregular drought relief programmes.

TABLE 1.2: GOVERNMENT BUDGET 2007/08 – 2009/10 (P MILLION)

	2007/08			2008/09		2009/10
	Budget	Revised	Final	Budget	Revised	Budget
Revenue	**27 179**	**27 178**	**28 629**	**29 889**	**29 681**	**24 393**
Mineral revenue	10 890	10 890	11 604	10 558	10 860	6 835
Non-mineral	16 289	16 288	17 025	19 331	18 821	17 558
Expenditure	**26 441**	**26 391**	**24 822**	**30 220**	**35 877**	**37 787**
Recurrent	19 245	18 732	18 579	21 836	23 498	27 357
Of which						
Personal Emoluments	7 086	7 720	6 850	7 910	7 997	9 576
Development	7 257	7 720	6 548	8 500	12 495	10 558
Net lending	– 61	– 61	– 305	– 116	– 117	– 128
Balance	**738**	**787**	**3 808**	**- 331**	**–6 195**	**–13 394**

Source: Government of Botswana

of 2008,[16] and are unlikely to be much, if at all, improved in early 2009. However, this does not mean that the overall budget deficit will be larger than indicated in the revised estimates, as significant underspending, in particular of the development budget, remains the likely outcome. In the first nine months of 2008/09, development spending amounted to only 63 percent of the revised budget, even after the one-off impact of the equity contribution to the Morupule expansion project.

(b) 2009/10 Budget Proposals

(i) Budget Strategy and Supporting Framework

2.7 The Budget Speech acknowledged that the proposals for 2009/10 had been prepared in extremely difficult circumstances, with insufficient time to take proper account of the fiscal implications of the global financial crisis.[17] In developing the fiscal response to the crisis, it is necessary to achieve an appropriate balance between two major considerations. On the one hand, domestic demand can be supported through government spending: this is particularly important in Botswana, both given the size of the government sector relative to the economy and because the main link between the mining sector and the rest of the economy has been through the use of mineral revenues to finance public spending. In this context, if spending is maintained, especially in areas where a productive return can be anticipated and where it makes good use of resources that might otherwise be underutilised, fiscal policy can be expected to be supportive of economic growth.

2.8 In the case of Botswana, financial reserves have been accumulated over many years when both the government budget and balance of payments have been in structural surplus.[18] Hence, Botswana is relatively well placed to pursue a more 'Keynesian'[19] orientation to fiscal policy that seeks to offset the economic contraction in other sectors. However, the duration of the recession is also critical, in that it could create problems if it were to be so prolonged as to seriously erode the available months of import cover from the foreign exchange reserves.

16 Between October and December 2008, receipts of mineral taxes were zero, while royalties and dividends amounted to only P888 million, compared to an average of P2.6 billion in the two preceding quarters, and which was mainly concentrated in October.

17 While there was some scope for delaying the approval of NDP 10 so that the impact of the crisis could be incorporated, this was not an option for the 2009/10 Budget, which must be in place for the start of the financial year.

18 From 2004/05 to 2007/08, the cumulative balance of payments and budget surpluses were 12.2 percent and 5.3 percent of GDP, respectively.

19 Named after the British economist, John Maynard Keynes, who advocated the use of counter-cyclical policies of 'demand management' to combat economic slowdowns.

2.9 To help deal with this challenge, the budget, which is reviewed in more detail below, was supplemented by two supporting innovations, introduced in the context of the budget entering a period, possibly prolonged, of substantial deficits. First, spending plans are to be subjected to a detailed review to identify areas where cutbacks may be possible, either because the activities are of lower priority or because they could be undertaken more efficiently. Second, to offset the impact on public finances of a much larger budget deficit anticipated for 2009/10, the Government has committed itself to holding the deficit within an average of 10 percent of GDP over the next two fiscal years (i.e., 2009/10 and 2010/11).

2.10 In addition, the Budget Speech also reaffirmed the Government's commitment to remain within the fiscal rules that have underpinned the budget since their adoption in 2005 as part of the Mid-Term Review of NDP 9. Most importantly, these require that total expenditure be no more than 40 percent of GDP. While the budget proposals for 2009/10 conformed to this rule, the Speech noted that the outlook could worsen. In this regard, a particular concern is that faster economic growth may not resume in 2010/11, as is assumed in the Budget Speech. If this were to occur, it could require the Government to follow through with more extensive belt tightening measures to maintain spending within its own self-imposed guidelines.

2.11 To further support these commitments to fiscal sustainability, it is desirable that Government's budget strategy over the full NDP 10 period is put in place in order to reinforce, or even replace,[20] the current short-term commitments regarding control of budget deficits. The Government might also consider whether greater transparency about the details and underlying assumptions for the forecasts of GDP would further enhance the credibility of the fiscal rules.

20 The maintenance of the average budget deficit to an average of 10 percent of GDP over two years signals the Government's commitment to fiscal prudence.

(ii) Budget Balance

2.12 The estimated budget deficit for 2009/10 is P13.4 billion which, using the Government's forecast is 14 percent of GDP. This is the result of budgeting for a continued increase in expenditure to P37.8 billion, while forecasting a fall in revenue to P24.4 billion.

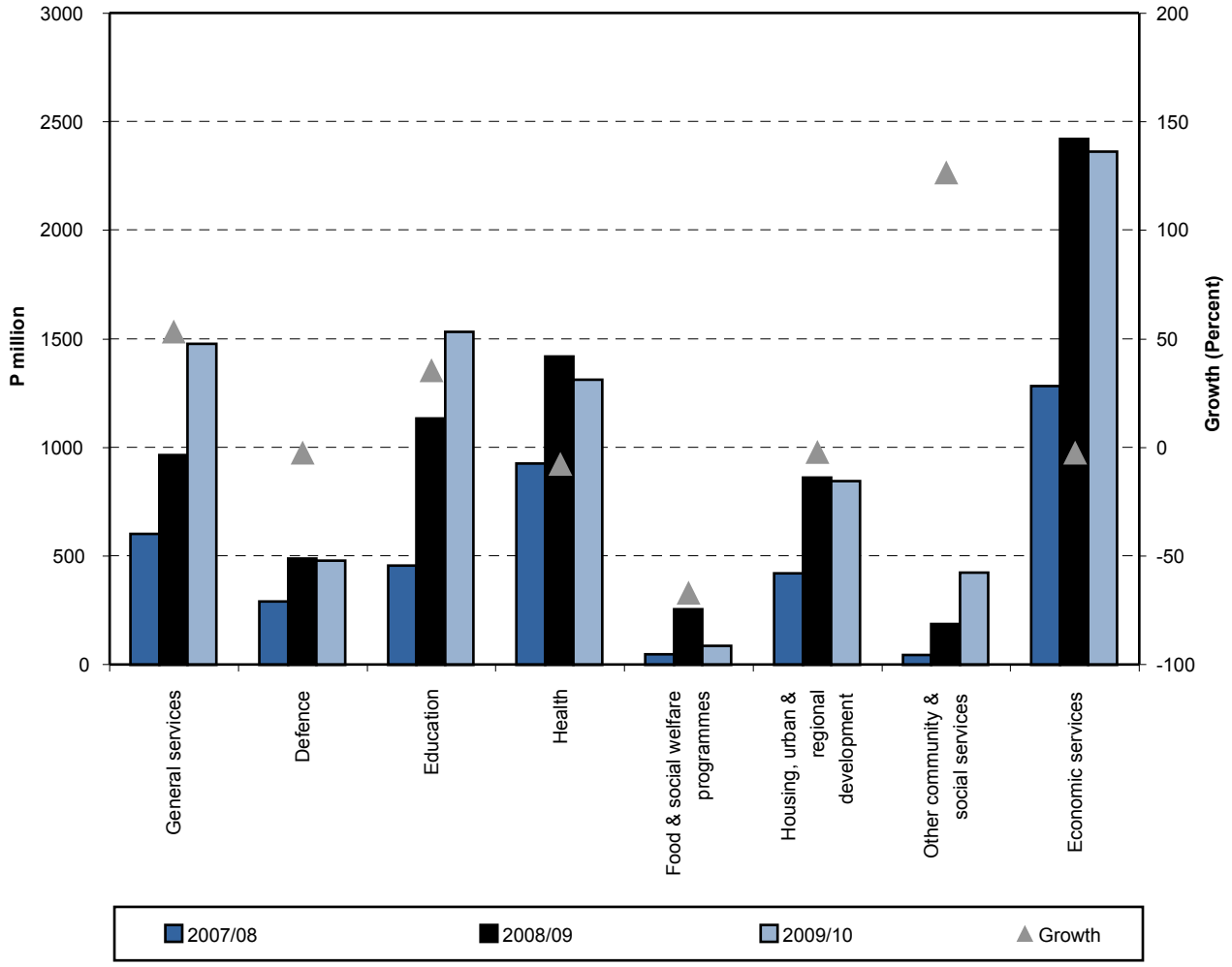
(iii) Revenue

2.13 Total receipts of P24.4 billion represent a large fall of 17.8 percent in expected revenues and grants from the revised budget estimates of 2008/09. This reflects the expectation that mineral revenues will be adversely affected throughout 2009/10. As a result, revenues from this source are expected to fall by 37 percent, from P10.9 billion to P6.8 billion, and will result in payments from SACU of P7.1 billion becoming the largest revenue source. In turn, the expected fall in mineral revenue is based on a forecast of a 50 percent decline in diamond sales in 2009. However, even a fall of this magnitude may be seen as optimistic, as it is based on assumptions of a fall in prices and sales volume of 15 percent and 35 percent, respectively.

(iv) Expenditure

2.14 The 2009/10 expenditure and net lending budget amounts to P37.8 billion, P1.9 billion or 5.3 percent higher than the revised budget for 2008/09. Recurrent expenditure is estimated at P27.4 billion, exceeding the final budget of 2007/08 by 52.3 percent and the 2008/09 revised budget by 16.4 percent. Ministries responsible for the largest increase in the recurrent expenditure are Education and Skills Development with an increase of P1.1 billion; Local Government with an additional P0.7 billion; followed by the ministries of State President and Health, each with P0.4 billion. In order to hold back growth in recurrent spending in the context of the deteriorating revenue forecast, there will be no cost-of-living adjustment for civil servants' salaries in 2009, while the travel budget is frozen and creation of new positions in the civil service is to be restricted to clearly identified special

CHART 1.8: DEVELOPMENT SPENDING BY ECONOMIC SECTOR (2007/08 – 2009/10)



Source: Government of Botswana.

cases, such as the staffing of new schools and health facilities.

2.15 At P10.6 billion, development spending is estimated to be 15.5 percent lower than the revised figure for 2008/09. This fall in the development budget is from very high levels that in 2008/09 include extraordinary items, and represents a further acceleration in underlying spending.[21] The considerable increase over the two years signifies the Government's intentions to continue, where possible, undertaking projects in an effort to support economic growth. Most of the proposed spending covers projects that have already commenced and where curtailment would be both disruptive and wasteful. The Ministry of State President was allocated the largest share of P2.1 billion or 19.8 percent of the budget, with the HIV/AIDS programme taking the largest share of this allocation. Since several major infrastructure development initiatives to be undertaken fall under the Ministry of Local Government, the Ministry was allocated the second largest share, amounting to P1.5 billion. The Ministry of Works and Transport under which the maintenance and construction of airports and major roads fall, got the third largest allocation of P1.3 billion. A detailed breakdown of the development budget by economic sector is shown in Chart 1.8. However, the Budget Speech warned that these budgetary allocations may be adjusted in light of the proposed detailed spending review.

21 The 2009/10 development budget is 61.2 percent higher than actual development expenditure during the 2007/08 fiscal year.

(c) Fiscal Legislation

2.16 The Budget Speech did not contain any specific proposals for changes to fiscal legislation. The 2008 speech had announced Government's intentions to undertake a comprehensive review of the Income Tax Act and the Value Added Tax Act, with a view to simplifying the laws, provide an enabling environment for investors and improve tax compliance. The agreed recommendations arising from a consultancy report are to be submitted to Cabinet and Parliament later in 2009.

3. EXCHANGE RATES, BALANCE OF PAYMENTS AND INTERNATIONAL INVESTMENT POSITION

(a) Exchange rates

3.1 During 2008, the exchange rate policy continued to focus on maintaining the country's competitiveness as measured by the real effective exchange rate (REER).[22] The major thrust of the exchange rate policy is to maintain a stable and competitive exchange rate against a basket of currencies of major trading partners (comprising the South African rand and the Special Drawing Right (SDR)),[23] as a means of supporting the competitiveness of local producers of tradeable goods and services in both domestic and international markets. The crawling band exchange rate mechanism introduced in May 2005 supports REER stability through a continuous adjustment of the Pula at a rate based on the differential between the Bank's inflation objective and forecast inflation for trading partner countries.

TABLE 1.3: PULA EXCHANGE RATES AGAINST SELECTED CURRENCIES

Nominal Exchange Rates (foreign currency per Pula)

As at end of	2007	2008	Percentage change
SA rand	1.1318	1.2455	10.0
US dollar	0.1665	0.1330	–20.1
Pound Sterling	0.0833	0.0921	10.6
Japanese yen	18.63	12.00	–35.6
Euro	0.1129	0.0944	–16.4
SDR	0.1053	0.0861	–18.2
NEER (index, September 2006 = 100)	**96.1**	**94.0**	**–2.3**
Real Pula Exchange Rate Indices (September 2006 = 100)			
SA rand[1]	95.7	108.6	13.5
SA rand[2]	93.4	106.8	14.3
US dollar	111.8	101.4	–9.3
Pound Sterling	103.1	128.5	24.6
Japanese yen	109.1	79.5	–27.1
Euro	96.4	90.2	–6.4
SDR	104.6	96.6	–7.7
REER (Core)[1]	**98.9**	**103.4**	**4.5**

1. Calculated using South African core inflation. Core inflation is derived from the all items consumer price index excluding mortgage interest costs and prices of various volatile food items.
2. Calculated using South African headline inflation.

Source: Bank of Botswana.

3.2 During 2008, the nominal effective exchange rate (NEER) of the Pula depreciated by 2.3 percent. Bilaterally, the Pula depreciated against most major international currencies, with the notable exception of the British pound, against which it appreciated by 10.6 percent. The Pula weakened significantly against the Japanese yen by 35.6 percent, against the US dollar by 20.1 percent and against the euro by 16.4 percent. The overall depreciation of the Pula against the SDR was 18.2 percent. Against the South African rand, the Pula appreciated by 10 percent, a reflection of the rand's depreciation against the SDR by 25.6 percent.

3.3 The Pula appreciated by 13.5 percent in real terms against the South African rand,[24] while

22 A trade weighted exchange rate of the Pula (against a fixed basket of currencies), after allowing for relative inflation, and is considered an appropriate measure of the relative competitiveness of Botswana goods and services vis-à-vis foreign goods and services in both the domestic and international markets.

23 The SDR is the unit of account of the IMF, comprising the US dollar, euro, Japanese yen and British pound.

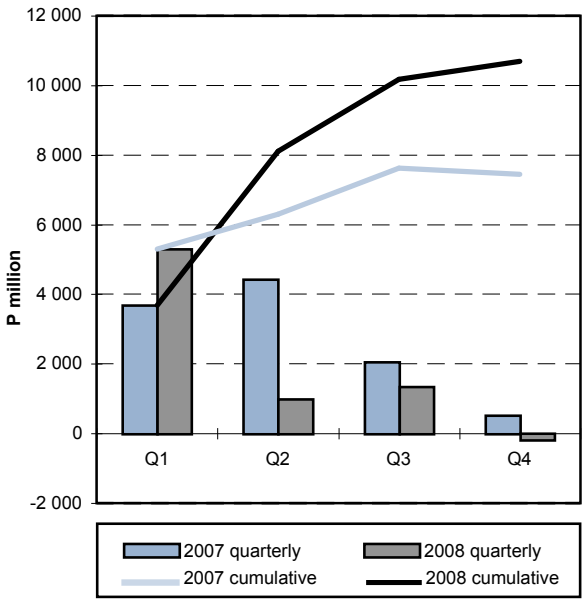
24 Calculated using South African core inflation.

it depreciated by 7.7 percent against the SDR. Against the individual components of the SDR, the Pula registered a mixed performance; it registered an appreciation of 24.6 percent against the British pound, whilst it depreciated substantially against the yen, dollar and euro, by 27.1 percent, 9.3 percent and 6.4 percent, respectively. Overall, the REER appreciated by 4.5 percent compared to a depreciation of 1 percent in 2007. This overall appreciation was due to the substantial positive differential between inflation in Botswana and in trading partner countries and, together with greater volatility in bilateral real exchange rate movements, underscores the need for action, beyond reliance on the exchange rate, for attaining lasting international competitiveness. In particular, measures to improve productivity, both of labour and business operations in general, are essential.

(b) Balance of Payments

3.4 Calculated from changes in the foreign exchange reserves, the overall external balance for 2008 was P7.5 billion, a decline of P3.2 billion compared to P10.7 billion in 2007. Chart 1.9 shows the quarterly breakdown of the overall surplus in 2007 and 2008. The impact of the worsening global economic crisis is particularly clear: 71 percent (P5.3 billion) of the total surplus in 2008 was accumulated in the first quarter due, principally, to a current account surplus of P4.2 billion; conversely, there was a small overall deficit of P177 million in the fourth quarter, when the overall balance deteriorated sharply due to a trade deficit of P2.7 billion.

CHART 1.9: QUARTERLY BALANCE OF PAYMENTS 2007 – 2008 (P MILLION)



Source: Bank of Botswana

(i) *Current Account*

3.5 Preliminary estimates for the current account, which is the sum of the balances of trade in goods and services, the income account and current transfers, show a surplus of P6.4 billion in 2008, compared to P10.8 billion in the revised estimates for 2007, a decline of 40.9 percent.

Merchandise Trade

3.6 Total exports are estimated at P33.5 billion in 2008, an increase of P2.6 billion from the revised estimate for 2007 of P30.8 billion. Export growth in 2008 was 8.5 percent, down from 16.9 percent the previous year, with the slower growth being mainly attributable to falling global demand for minerals due to the global economic slowdown. This resulted in declines in both volumes and prices of exports, especially in the final quarter of the year. Diamonds, which have historically been the main contributor to exports, did not perform well in the fourth quarter of 2008, with much reduced sales in November and December. However, up to October, diamond exports stood at P20.8 billion, which was already higher than the total of P20.5 billion for the whole of 2007. This reflects a strong performance for most of the year in the diamond markets, with prices for rough diamonds increasing by an average of 20 percent before starting to fall later in the year.[25] Due to growth in downstream processing (cutting and polishing) of diamonds prior to export, processed diamonds accounted for about 10 percent of total diamond exports in 2008.

25 Estimates of the downward pressure on prices for rough diamonds vary widely.

TABLE 1.4: BALANCE OF PAYMENTS: 2004 – 2008 (P MILLION)

	2004	2005	2006	2007[1]	2008[2]
Current Account	1 641	7 972	11 319	10 838	6 406
Of which:					
Merchandise trade	3 904	8 982	11 115	9 702	3 010
Services	–237	–154	–372	–1 104	–1 631
Income	–4 496	–4 293	–4 509	–4 544	–1 883
Net current transfers	2 469	3 437	5 086	6 784	6 910
Capital account	149	344	142	493	703
Financial account	–1 556	–774	–1 030	–1 398	–693
Net errors and omissions	–558	–507	–176	760	1 036
Overall balance	–324	7 036	10 256	10 694	7 452

1. Revised
2. Provisional

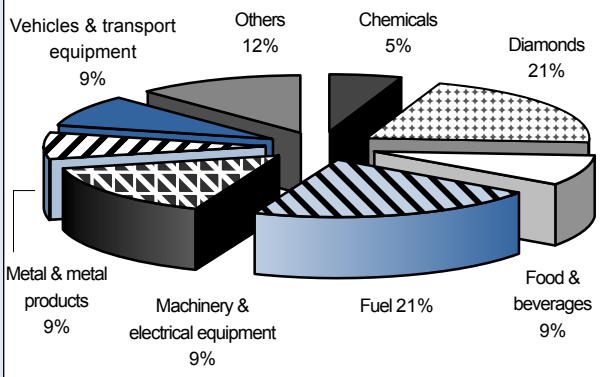
Source: Bank of Botswana.

3.7 In contrast, prices of copper and nickel fell sharply during much of 2008, by about two-thirds from mid-year highs in both cases. However, generally high prices in the first months of the year meant that the adverse impact on exports was more muted, with total exports of copper and nickel in 2008 falling by a moderate 7.3 percent to P5.1 billion.[26] In contrast, gold exports rose by 59.8 percent to P382 million, as demand for the metal as a store of value at a time of global economic uncertainty remained strong.

3.8 Adversely affected by outbreaks of foot and mouth disease, beef exports declined by 10.5 percent in 2008, to P530 million. Textile exports, which had more than doubled in 2007, fell by 16.9 percent in 2008. While demand was generally steady throughout the year, a sharp fall in December signalled the negative impact on demand for clothing from falling consumer spending in destination markets.

3.9 Merchandise imports in 2008 increased by 44.1 percent from P21.1 billion in 2007 to P30.5 billion and have almost doubled since 2006. To some extent this was due to higher prices of food and fuel which prevailed for much of the year, with imports in these two categories rising by 25.4 percent and 53.2 percent, respectively. However, these were not the only sources of rapid import growth (Chart 1.10 indicates the principal contributions to overall import growth by commodity group).[27] Of almost equal importance to rising fuel costs was growth in imports of diamonds, which rose from P786 million in 2007 to P2.8 billion in 2008, and accounted for 20.9 percent of increased imports. Growth in diamond imports (including both rough and partially processed stones), which in 2005 were only P153 million, is due to the increasing importance of diamond-related manufacturing in Botswana. Other important sources of growth included

CHART 1.10: CONTRIBUTION TO IMPORT GROWTH 2008



Source: Central Statistics Office.

26 Exports in 2007 had also been held back by the temporary closure for maintenance work of the smelter at the BCL mine.

27 That is, the increase in commodity groups, imports as a proportion of overall import growth.

BOX 1.2: RECENT CHANGES IN THE DIRECTION OF BOTSWANA'S TRADE

Table 1.5 ranks the top ten markets for Botswana's exports and imports in 2005 and 2008. The United Kingdom and South Africa remain firmly established as the major destination for exports and source of imports, respectively. However, there have been major changes elsewhere in the rankings.

TABLE 1.5: DIRECTION OF TRADE: TOP TEN TRADING PARTNERS, 2005 AND 2008 (PERCENTAGE SHARES)

	Exports				Imports			
Rank	**2005**		**2008**		**2005**		**2008**	
1.	UK	75.7	UK	57.2	RSA	84.1	RSA	78.6
2.	RSA	8.8	RSA	19.2	Sweden	3.1	UK	5.8
3.	Norway	5.9	China	4.9	Zimbabwe	1.5	China	2.8
4.	Zimbabwe	4.2	Zimbabwe	4.5	UK	1.3	Israel	1.7
5.	USA	2.2	Israel	3.2	USA	1.3	Belgium	1.2
6.	Germany	0.6	Belgium	2.6	China	1.1	USA	1.2
7.	Zambia	0.3	Norway	1.4	Germany	0.9	Zimbabwe	0.9
8.	Israel	0.2	Switzerland	1.1	India	0.7	Germany	0.8
9.	Belgium	0.2	USA	1.0	Japan	0.7	India	0.7
10.	Namibia	0.2	Zambia	0.8	Namibia	0.5	Japan	0.7

Source: Central Statstics Office.

Significant changes to note include the following:

a) the growing importance of both Israel and Belgium for both imports and exports. Both these countries are major diamond centres where the parent companies of many of the cutting and polishing companies now established in Botswana are based. The flow of both imports and exports includes movement of goods between the parent companies and their Botswana subsidiaries;

b) also related to the developing diamond business in Botswana, the United Kingdom has become an increasingly important source of imports, ranking second due to imports of rough diamonds to supplement local supply;

c) China is increasingly important as a trading partner. This is particularly for exports where it is now the third most important market, having not even been in the top ten in 2005. Notably, since 2007 Botswana has had a bilateral trade surplus with China due, in part, to growth in exports of commodities such as nickel ore;

d) the United States has declined in importance as a trading partner. This is despite Botswana having preferential access to US markets through African Growth and Opportunity Act (AGOA), with data indicating that most of Botswana's exports of textile products go to markets other than the USA.[1]

1. In 2008, exports of textiles totaled P1.8 billion, of which only P329 million was to the USA.

machinery and electrical equipment, metal and metal products and vehicles and transport equipment, reflecting rapidly rising capital expenditure associated with the development of both public and mining infrastructure.[28]

3.10 For many years, the structure of Botswana's trade regarding the main sources of imports and destination of exports has been relatively simple. In particular, imports have mainly come from South Africa, while exports have been dominated by sales of rough diamonds to the United Kingdom prior to worldwide distribution. However, in recent years there have been major changes in the direction of trade for both imports and exports, due to both the growth of downstream diamond-related businesses and increased trading links with other markets such as China. This is discussed in Box 1.2.

28 In 2007/08, it is estimated that gross fixed capital formation grew by 15.9 percent in real terms, with investment in machinery and equipment and transport equipment growing by 23 percent.

Income Account

3.11 The income account registered a lower deficit of P1.9 billion in 2008 compared to the revised deficit of P4.5 billion in 2007. As in previous years, the credit side of this account is mainly the earnings from the foreign exchange reserves and the offshore investments by pension funds, while debits comprise dividends and profits of foreign companies operating in Botswana, and include both actual remittances and retained earnings. It should be noted that retained earnings are matched by an equivalent imputed inflow, representing an inward direct investment, in the financial account.

Current Transfers

3.12 Net current transfers in 2008 were P7 billion, up from P6.8 billion in 2007. This growth of 2.9 percent reflected increased net payments from SACU.

(ii) Capital and Financial Accounts

3.13 The capital account mainly comprises capital grants to Government and migrants' transfers. The surplus on this account continued to grow, from P493 million in 2007 to P703 million in 2008, with capital grants to Government accounting for 95 percent of net receipts.

3.14 The financial account is made up of direct investment, portfolio investment and 'other investment', and shows an estimated net outflow of P693 million in 2008. This is accounted for by a deficit of P2.5 billion on 'other investment', mainly due to acquisition of foreign assets by Botswana banks. In contrast, portfolio investment showed a net surplus of P1.9 billion resulting from sales of equities. Flows of direct investment in and out of Botswana were broadly balanced, with estimated net outflows of P21 million.[29]

(iii) Foreign Exchange Reserves

3.15 At the end of 2008, the foreign exchange reserves amounted to P68.6 billion, compared to P58.5 billion in 2007, and equivalent to 23 months of imports of good and services. The increase of 17 percent in local currency terms was due to the depreciation of the Pula against most of the currencies in which the reserves are held. In US dollar and SDR terms, the reserves fell by 6.9 percent to USD9.1 billion, and by 4 percent to SDR5.9 billion, respectively. While the reserves have been boosted by the large overall balance of payments surplus in 2008, net outflows occurred towards the end of the year as exports fell sharply, while the value of the reserves in hard currency terms has been eroded by losses on world equity markets arising from the economic crisis. During 2008, the benchmark Dow Jones and FTSE 100 indices for the New York and London Stock Exchanges fell by 29 percent and 31 percent, respectively,[30] although higher prices for bonds, which made up two thirds of the reserves at the end of 2008,[31] offset the impact to some extent. The larger fall of the reserves in dollar terms was due to the more substantial appreciation of the US dollar, reflecting its status as a 'safe haven' for investors at times of economic uncertainty.

TABLE 1.6: FOREIGN EXCHANGE RESERVES, 2007 – 2008 (P MILLION)

End of:	Pula	SDR	US dollar
December 2007	58 518	6 191	9 790
March 2008	67 392	6 234	10 237
June 2008	65 377	6 132	10 002
September 2008	65 901	6 214	9 589
December 2008	68 612	5 942	9 118

Source: Bank of Botswana.

29 For balance of payment purposes, direct investment mainly refers to significant holdings of equity by foreign entities in domestic business; foreign investment financed by borrowing is, in most cases, classified as 'other investment'.

30 Sharp falls in the indices continued in early 2009, with the Dow Jones losing a further 27 percent and the FTSE 100 losing 20 percent in January and February.

31 See note 12 of the annual financial statements.

(c) Balance of Payments Outlook

3.16 Due to slack demand for exports, particularly of minerals, but also for manufactures, arising from the current economic slowdown, the current account is expected to come under pressure in the short-to-medium term. Whether this also extends to the longer term will be determined by the success of policy makers in reviving global demand, including restoring the smooth flow of bank credit. But it would be unwise to assume that demand for diamonds will recover quickly. Exports of services, notably tourism, are also expected to be adversely affected, although the impetus to regional tourism from the 2010 World Cup in South Africa will provide some support. There will be some offsetting reduction of imports, especially of inputs into mining related industries as well as due to lower fuel prices. However, this is unlikely to be sufficient to prevent a serious deterioration in the trade balance. Net current transfers will remain in surplus due to SACU receipts, although these may also be reduced as regional economic activity slows.

3.17 It had previously been expected that smaller current account surpluses would be offset by increased surpluses on the capital and financial accounts. However, while some investments are still likely to go ahead, the prospects for major capital inflows are considerably diminished. Thus, the extent of overall balance of payments surpluses will be similarly reduced, with a period of deficits now a possibility.

(d) International Investment Position (IIP) and Foreign Investment

3.18 Data for the detailed IIP, which records the stock of foreign assets and liabilities, are available up to 2007. Only major aggregates have so far been estimated for 2008, using information on financial flows during the year. During 2009, planned participation in the Co-ordinated Direct Investment Survey (CDIS) undertaken by the IMF is expected to further improve the quality of information on investment in Botswana, and by Botswana-based entities in other countries.

(i) International Investment Position in 2008

3.19 According to the preliminary estimates, during 2008 Botswana's foreign assets increased from P89.4 billion at the end of 2007 to P98 billion. Of this, the largest portion was the foreign exchange reserves, which accounted for 70 percent of the total. Portfolio investment abroad declined by 13.3 percent from P20.9 billion to P18.1 billion, while direct investment abroad rose marginally to P8 billion.

3.20 Total foreign liabilities showed a decline of 8.7 percent from P14.9 billion in 2007 to P13.6 billion at the end of 2008, due to falls in both direct and 'other' investment. There was a substantial decrease in portfolio investment to P1.3 billion in 2008 due to reclassification of some figures between direct and portfolio investment. Overall, the net international investment position shows an increase of 13.4 percent from P74.5 billion to P84.5 billion.

(ii) Investment in Botswana in 2007 by Industry and Country

3.21 Tables 1.7 and 1.8 show Botswana's stock of foreign liabilities at the end of 2007, classified by industry and country, respectively.[32] The statistics indicate that 92 percent of total foreign direct investment in Botswana was in mining and finance, with mining accounting for a bigger share of the total of P5.8 billion. The same sectors also dominate 'other investment', although the Government's external debt, which is classified under public administration, contributed 20 percent in this category.

3.22 Europe continued as the major source of foreign direct investment into Botswana, with 59 percent. Luxemburg makes up the bulk (83 percent)

32 Figures in these two tables are based on the 2007 Balance of Payments Survey conducted by the Bank of Botswana. It should be noted that figures refer to aggregate stocks of investment at the end of the year rather than new investment during the year. The data need to be treated with caution due to challenges arising from maintaining survey coverage and achieving satisfactory response rates. Efforts to make improvements in these areas are on-going.

TABLE 1.7: STOCK OF FOREIGN INVESTMENT IN BOTSWANA BY INDUSTRY, END OF 2007 (P MILLION)

	Direct Investment			Other Investment		
Industry	**Equity**	**Non-equity**	**Total**	**Equity**	**Non-equity**	**Total**
Mining	3 299	0	3 299	0	3 704	3 704
Manufacturing	71	19	90	0	327	327
Finance	1 983	67	2 050	1 265	1 061	2 326
Retail and Wholesale	8	136	144	0	356	356
Electricity, Gas and Water	0	0	0	0	270	270
Real Estate and Business services	116	0	116	0	73	73
Transport, Storage and Communication	33	6	39	0	49	49
Construction	5	3	8	0	10	10
Hospitality	32	0	32	0	1	1
Public Administration	0	0	0	0	1 907	1 907
Other	18	23	41	0	438	438
Total	**5 565**	**254**	**5 819**	**1 265**	**8 197**	**9 462**

Source: Bank of Botswana

TABLE 1.8: STOCK OF FOREIGN INVESTMENT IN BOTSWANA BY COUNTRY, END OF 2007 (P MILLION)

	Direct Investment			Other Investment		
Country	**Equity**	**Non-equity**	**Total**	**Equity**	**Non-equity**	**Total**
North and Central America	**418**	**0**	**418**	**0**	**2**	**2**
Of which						
United States	418	0	418	0	2	2
Europe	**3 374**	**39**	**3 414**	**0**	**3 928**	**3 928**
Of which						
United Kingdom	472	24	496	0	291	291
Netherlands	51	5	56	0	0	0
Luxembourg	2 832	0	2 832	0	446	446
Other Europe	20	10	30	0	3 192	3 192
Asia Pacific	**6**	**47**	**52**	**0**	**5**	**5**
Africa	**1 694**	**168**	**1 862**	**1 265**	**1 736**	**3 001**
Of which						
South Africa	1 597	161	1 758	0	1 417	2 683
Middle East	**61**	**0**	**61**	**0**	**77**	**77**
Other	**11**	**0**	**11**	**0**	**2 449**	**2 449**
Total	**5 565**	**254**	**5 819**	**1265**	**8 197**	**9 462**

Source: Bank of Botswana

of Europe's stock of foreign direct investment in Botswana, the result of the source of major mining investments in the country. South Africa was also a significant contributor to foreign direct investment, reflecting the involvement of South African financial institutions in Botswana. Similarly, Europe also had the largest share of other investment, (with 'other Europe' as the major source, again a reflection of mining investments).

4. MONEY AND CAPITAL MARKETS

(a) Monetary Policy and Liquidity Management

4.1 The objective of monetary policy is to achieve low, predictable and sustainable inflation, which contributes to macroeconomic stability

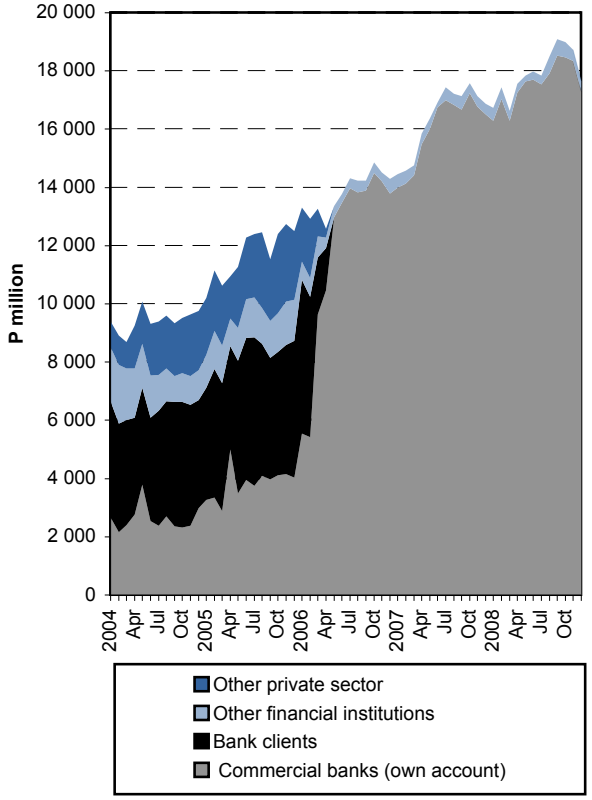
and fosters stability of the real effective exchange rate, thereby contributing towards international competitiveness of domestically produced tradeable goods and services. Among the significant developments in monetary policy in 2008 was the decision by the Bank of Botswana to discontinue the use of an annual inflation objective, leaving only the medium-term objective of 3 – 6 percent. The shift in focus to a single, longer-term objective recognised that the monetary policy transmission process from changes in interest rates to the impact on inflation involves a time horizon of more than one year. The medium-term inflation objective is, therefore, intended to anchor inflation expectations beyond the short term and affords the Bank sufficient time to direct policy actions to the sources of inflation that are directly under the influence of monetary policy. Moreover, it gives the Bank time to evaluate the monetary policy framework and make appropriate changes where they are required to achieve the price stability objective.

4.2 Another change to the Bank's monetary policy framework was the replacement of the annual growth in commercial bank private sector credit with a more inclusive inflation forecast as an intermediate target that informs a systematic response to deviations of the forecast from the inflation objective. The annual growth in credit to the private sector, although an important indicator of demand pressures, is determined by other factors unrelated to changes in monetary policy. Therefore, the inflation forecast, which results from a broad-based assessment of prospective developments with respect to a wider range of factors, is a more appropriate means for determining the inflation outlook.

4.3 The monetary environment in 2008 was challenging, with inflation rising for most of the year and remaining above the upper end of the medium-term inflation objective, due to the substantial increase in international oil and food prices and resulting second-round effects in conditions of buoyant demand and substantial monetary expansion in the domestic economy. In consideration of the adverse inflation outlook, the Bank Rate was increased by 50 basis points to 15 percent in May and by another 50 basis points to 15.5 percent in June. However, in December, the Bank Rate was reduced by 50 basis points, on account of improved inflation prospects that arose from a decrease in international oil prices, which led to a reduction in the domestic fuel price. Moreover, it was also anticipated that inflation would moderate in the context of slower growth that was resulting from the global financial crisis.

4.4 In order to manage excess liquidity in the domestic banking system, the Bank conducted open market operations during the year to ensure that short-term interest rates, in particular yields on Bank of Botswana Certificates (BoBCs), were consistent with the monetary policy stance. Consequently, in

CHART 1.11: OUTSTANDING BANK OF BOTSWANA CERTIFICATES (BoBCs)



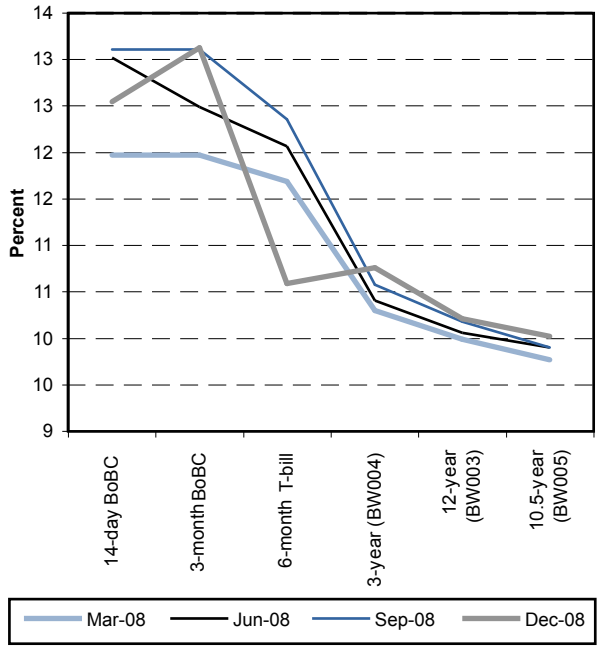
Source: Bank of Botswana.

Note: Since March 2006, holdings of BoBCs have been restricted to commercial and merchant banks only; hence, holdings of banks' clients and other private sector fell to zero.

2008, both the nominal 14-day and 3-month BoBC rate ranged between 12 percent and 13.1 percent, with the highest yields occurring in October.[33]

4.5 The total outstanding BoBCs increased by 4.5 percent to P17.6 billion in 2008, compared to growth of 18.7 percent in 2007, with the slower increase partly reflecting the substitution by some market participants into holding government securities, for which there is now a regular issuance programme. Commercial banks held 98 percent of total outstanding BoBCs at the end of the year, while the remainder were held by a merchant bank.[34]

CHART 1.12: YIELD TO MATURITY ON BoBCs AND GOVERNMENT BONDS



Source: Bank of Botswana.

Note: Because of its earlier issuance date (March 2003), the 12-year bond (BW003) matures in March 2015, earlier than the 10.5-year bond (BW005) which matures in September 2018.

(b) Interest Rates

4.6 As already noted, the Bank Rate was changed three times in 2008. Following the increases in May and June, commercial banks increased their prime lending rates by the same magnitude, first to 16.5 percent and then 17 percent. When the Bank Rate was lowered by 50 basis points to 15 percent in December, prime lending rates were accordingly cut to 16.5 percent. Overall, deposit rates were unchanged, with the average rate on commercial banks' 88-day deposits at 8.5 percent in December 2008, the same as at the end of 2007.

4.7 There were large variations in real money market interest rates in 2008, indicating that the movements in nominal rates were much less than the fluctuations in inflation during the year. The real 3-month BoBC rate averaged 0.1 percent across a range of –1.8 to 3.3 percent, compared to an average of 4.9 percent and a range of 3.6 – 6 percent in 2007 (Chart 1.13). Real lending rates similarly varied as the average real commercial bank prime lending rate fell sharply from 7.3 percent in December 2007 to a low of 1.7 percent in August 2008, before rising to 2.5 percent in December.

CHART 1.13: REAL INTEREST RATES: INTERNATIONAL COMPARISONS

Source: Bank of Botswana, Bloomberg, South African Reserve Bank.

33 The 14-day and 3-month BoBC rates are weighted averages of the winning bids at the regular auctions.

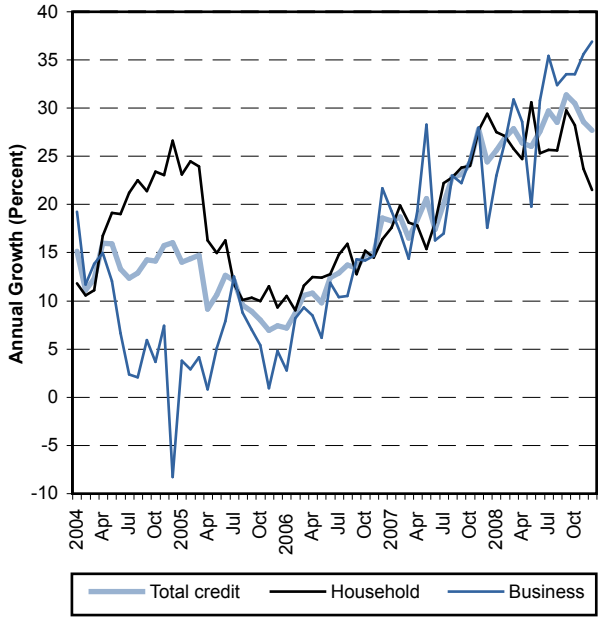
34 As well as commercial banks, merchant banks are also allowed to hold BoBCs; currently, there is one merchant bank operating in Botswana.

(c) Banking System

(i) Domestic Credit

4.8 The annual growth in commercial bank credit rose from 24.4 percent in December 2007 to 31.4 percent in September 2008, before slowing to 27.7 percent in December. The increase in credit growth during the year was due to rapid expansion of lending to the business sector, which accelerated from 17.6 percent in December 2007 to 36.9 percent in December 2008. Business sectors where credit growth was particularly rapid included mining, construction, and various services, while credit to manufacturing fell by 5.2 percent. In contrast, year-on-year growth in lending to households fell from 29.4 percent to 21.5 percent over the same period. As a result of slower growth, the share of household credit in total credit declined to 56.9 percent from 59.8 at the end of 2007.

CHART 1.14: COMMERCIAL BANK CREDIT GROWTH



Source: Bank of Botswana.

(ii) Monetary Aggregates

4.9 Annual growth of the broad measure of the money supply, M2,[35] was 21.1 percent in December, compared to 31.2 percent in 2007, and mostly reflected growth of 20.5 percent and 27.7 percent in net foreign assets and credit to private and parastatal sectors, respectively. Both the 6.8 percent increase in government deposits (mainly at the Bank of Botswana, but also elsewhere in the banking system)[36] and the 5.6 percent growth in BoBCs held by banks had a contractionary influence on the money supply, although this was partially offset by an eightfold increase in credit to the Government, thus reflecting holdings by depository corporations[37] of additional government bonds and treasury bills that were issued in 2008.

4.10 Currency in circulation outside banks and transferable deposits grew by 21.5 percent and 23.1 percent, respectively, while non-transferable deposits grew by 20.7 percent. In Pula terms, foreign currency accounts (FCAs), which accounted for 27.4 percent of the total value of deposits in the banking system, increased by 14.9 percent. The increase in foreign currency deposits was concentrated in deposits with maturities under six months. Holding foreign currency deposits can mitigate the impact of any adverse movements in the Pula exchange rate on the payments that Botswana residents might have to make for imports of goods and services, and capital transactions.

(iii) Bank of Botswana

4.11 Total assets/liabilities of the Bank of Botswana grew by 17.1 percent to P68.9 billion in

35 Since 2006, three monetary aggregates for Botswana have been published: M1 (narrow money); M2 (broad money); and M3 (M2 plus BoBCs not held by depository corporations). Full details of the composition of these measures can be found in Table 3.3 (Depository Corporations Survey) in the statistical section of this report. As well as commercial banks, depository corporations comprise other financial institutions that accept deposits. In Botswana these include merchant banks, the Botswana Building Society and Botswana Savings Bank. Since early 2006, M2 and M3 have been equivalent, due to the restriction on BoBCs being held only by banks; however, if a depository corporation issued eligible securities that are not subject to such a restriction, the two measures would diverge.

36 Following standard international practice, government deposits are not counted as part of the money supply.

37 See note 27 for an explanation of depository corporations.

December 2008 from P58.8 billion in December 2007. The expansion of the balance sheet in 2008 was largely a result of growth in government deposits at the Bank, which rose by 14 percent to P31.7 billion, as well as the increase in BoBCs. On the asset side, this was matched by growth in the foreign exchange reserves which, however, suffered some erosion in the final quarter of the year (Section 3 above).

(iv) Commercial and Merchant Banks

4.12 Despite the global financial crisis, the domestic banking sector performed robustly during 2008, with total assets and liabilities of commercial banks increasing by 21.4 percent to P43.8 billion, only marginally slower than 23.3 percent in 2007. The major contributor to growth in total assets was the increase in loans and advances, which grew by 27.4 percent. Balances at foreign banks rose by 58.9 percent, while other assets grew by 19.6 percent, boosted by banks' additional holdings of government bonds. In respect of sources of funds, the growth in assets was matched by total bank deposits, which increased by 22.4 percent to P37.3 billion in December 2008, the largest proportion of which (36.3 percent) were held in call deposits.

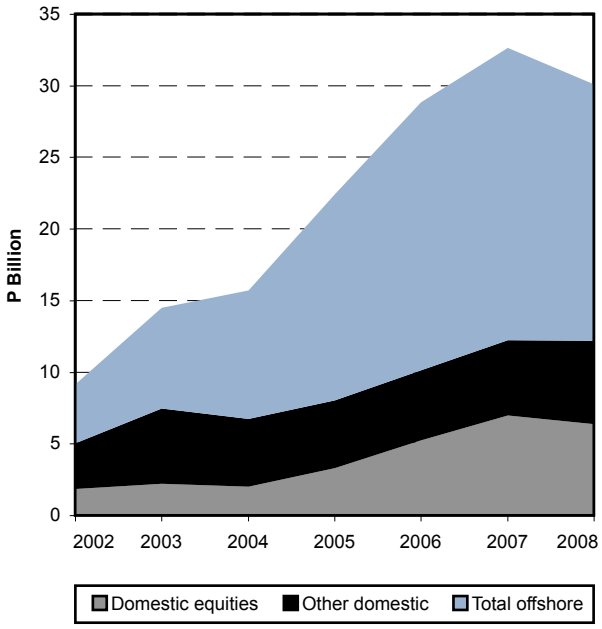
4.13 In 2008, total assets/liabilities of African Banking Corporation of Botswana (ABC), which is the only merchant bank operating in Botswana, increased by 31 percent to P1.6 billion in December 2008, compared to 9.1 percent in 2007. Loans and advances of ABC grew by 50.1 percent over the 12 months to December 2008, continuing the rapid growth of 51.3 percent in 2007, while deposits increased by 48.9 percent to P1.3 billion.

(d) Other Financial Institutions

4.14 The total assets/liabilities of the Botswana Building Society (BBS) increased by 8.1 percent over the 12 months to December 2008, compared to 15.5 percent in 2007. Loans and advances, the major proportion of which is mortgage loans, rose by 15.9 percent to P1.2 billion. However, cash and deposits at other banks decreased by 10.7 percent. With regard to the Botswana Development Corporation (BDC), year-on-year growth in assets/liabilities slowed to 5.9 percent in 2008, reaching P1.8 billion from 5.4 percent in 2007. The growth in overall assets was due to the 17.9 percent increase in loans, advances and leasing. In the case of the National Development Bank (NDB), the balance sheet grew by 10 percent, compared to 10.9 percent in 2007. Lending by the NDB grew by 32.8 percent, a significant increase from 6.1 percent recorded a year earlier. The total assets/liabilities of the Botswana Savings Bank (BSB) rose by 20.5 percent compared to 32.5 percent the previous year, with 26 percent growth in savings deposits, while liquid assets fell by 36 percent.

4.15 The Domestic Companies Index (DCI) of the Botswana Stock Exchange (BSE) lost 1391.2 points (or 16.5 percent) in 2008. This is in contrast with growth of 36 percent the previous year, although the downward trend first commenced in October 2007. In 2008 (between May and mid-October) the DCI more than recovered from losses in the first part of the year. However, for the remainder of the year the index was in steep decline, mainly reflecting weakening sentiment towards banking shares (which constitute the bulk of the DCI), while shares in Sechaba, a brewery holding company, lost value as a result of the special levy on alcohol introduced in November. Trading was active, with 286 million shares valued at P1.4 billion traded during the year, compared to 192 million shares valued at P821 million traded in 2007. Although market capitalisation of constituent companies fell by 17.8 percent to P26.9 billion during 2008, the DCI was largely insulated from the immediate impact of the global financial crisis, as all the listed mining companies are dual-listed on other exchanges and are, therefore, not included in the index. However, the effects of the crisis were seen in the foreign companies index which declined by 45.8 percent. The number of domestic listed

CHART 1.15: BOTSWANA PENSION FUND ASSETS (2002–2008)



Source: Non-bank Financial Institutions Regulatory Authority

companies remained at 20 in 2008, with one company listing and another de-listing from the BSE in the course of the year.[38] Similarly, the number of foreign companies listed on the exchange was unchanged at 11, with a de-listed company replaced by a South African financial services group. The Venture Capital Board comprised seven companies, of which six were mining-related.

4.16 In October 2008, pension fund assets stood at P30.3 billion, a decline of 11.7 percent from P34.3 billion in December 2007 (Chart 1.15). The most pronounced fall was in the value of offshore equities and dual listed equities, which were down 16.2 percent and 55.6 percent, respectively. This was offset to some extent by an increase of 13 percent in the value of offshore bonds. Reflecting the generally worse performance of offshore securities, the proportion of securities invested offshore fell, albeit marginally, from 59.6 percent to 59.2 percent.

4.17 In March 2008, the Government commenced a new bond issuance programme in support of capital market development, replacing the five-year bond that matured in March 2008 with a range of maturities, including six-month treasury bills, with a par value of P1.3 billion. There was a further round of issues in September and, as of December, the total par value of the outstanding bonds and treasury bills was P2.6 billion, with yields to maturity of 10.6 percent, 10.8 percent, 10 percent and 10.2 percent, for the treasury bill, 3-year bond, 10.5-year bond and the 12-year bond, respectively. In terms of distribution, foreign investors held P50 million (1.9 percent) of the government securities, while the Bank of Botswana held P40 million (1.5 percent) for potential secondary market activity. The remaining 96.5 percent was held by commercial banks and their customers. Further bond issues are expected in 2009, with funds raised contributing towards financing the substantial budget deficit that is expected.

(e) Credit Rating

4.18 During 2008, the international rating agencies, Moody's Investors Service (Moody's) and Standard and Poor's (S & P), reaffirmed the country's investment grade ratings for the eighth consecutive year. Importantly, in the environment of the deteriorating global economy, this reflected Botswana's continued sound financial position, as well as a consistent record of sound macroeconomic management. In this regard, Moody's ranked Botswana's institutional and financial strengths 'high' and 'very high', respectively. In this respect, the rating agency emphasised that, while economic growth was forecast to slow down and the budget expected to move into deficit, the Government's accumulated assets would mitigate the adverse impact of the economic downturn, while noting the country's potential to access the local capital market. Moreover, Moody's noted that Botswana's banking sector had remained relatively insulated from the global financial problems.

4.19 In assigning Botswana a stable outlook due to

38 Funeral Services Group (FSG) joined the exchange while MRIB, a medical services company, de-listed after being taken over.

its strong public sector balance sheet, S & P indicated that the deep global downturn was likely to have significant negative impact on Botswana's diamond exports, economic growth, fiscal outturns and external balances. Both agencies were positive that, despite the global financial crisis and economic slowdown, the probability of a significant future ratings downgrade was low, provided that implementation of necessary reforms continued to improve.[39]

(f) Other Financial Sector Developments

4.20 The Bank of Botswana, as the regulator of the International Financial Services Centre (IFSC) entities during 2008, issued four companies with Exemption Certificates. One company surrendered its licence, bringing the total number of financial companies licensed to operate under the auspices of IFSC from 19 in 2007 to 22 in 2008.

4.21 The Non-Bank Financial Institutions Regulatory Authority (NBFIRA) commenced operations on April 1, 2008. The establishment of NBFIRA is expected to close the remaining regulatory and supervisory gaps in the financial sector, including the regulatory oversight of insurance and asset management activities, which will further enhance the soundness and stability of the financial system. The Bank of Botswana and NBFIRA are cooperating in areas of mutual interest, including the further development of financial sector statistics.

4.22 Although no new bank licence was issued in 2008, Capital Bank Limited, which was licensed in 2007, commenced operation in May 2008, with one branch in Gaborone. The geographical representation of banks across Botswana increased due to additional branch openings and installation of automated teller machines. In other developments, 7 new bureaux de change were licensed, while 4 closed, resulting in 50 operating bureaux de change at the end of 2008. African Banking Corporation (International) Limited, which was licensed as an offshore bank in 2001, surrendered its licence in accordance with Section 11(2) of the Banking Act (CAP. 46:04).

4.23 Management companies licensed under the Collective Investment Undertakings (CIUs) Act increased from 3 in 2007 to 4 in 2008, following the licensing of Investec Fund Managers Botswana (Pty) Limited. The number of funds under management increased from 13 in 2007 to 14 in 2008. International management companies granted approval to market their funds in Botswana also increased from 4 in 2007 to 5 in 2008, while the total number of foreign licensed funds being marketed in Botswana increased from 20 to 21 in the same period. The growth in such investment avenues is expected to benefit savers.

4.24 During 2008, the banking industry was characterised by increased competition through, among others, aggressive marketing strategies and the introduction of new products. Furthermore, as indicated above, the industry remained relatively insulated from the on-going global financial crisis. However, the future remains uncertain, and this requires enhanced risk management practices.

39 However, in February 2009, S & P revised the foreign currency outlook from 'stable' to 'negative' due to the impact of the worsening global outlook on the government budget, and also pending the outcome of the proposed public spending review. Subsequently, for similar reasons, Moody's revised the foreign currency bond outlook from 'positive' to 'stable'.

CHAPTER 2
PRICE STABILITY UNDER INFLATION TARGETING

1. INTRODUCTION

1.1 Price stability (low, stable and predictable inflation) is recognised as an important element of broad macroeconomic stability, contributing to sustainable economic growth and rising living standards. While there are other influences on inflation trends, monetary policy has the primary role of attaining price stability. Monetary policy and operations influence the rate of increase in prices in the economy through regulation of the cost and availability of money in the economy and, in turn, the demand and supply for goods and services. Institutionally, central banks, have responsibility for implementing monetary policy, and this is supported and facilitated by the other complementary responsibilities they have, such as issuance of currency, supervisor and lender of last resort for banks, as well as oversight for payments and settlement systems. In this respect, a variety of monetary policy frameworks are in use and have evolved over time in response to, among others, changes in the economic structure and institutional relationships, and innovations in payments mechanisms and the financial architecture. Together, these result in variations in the monetary transmission processes: for example, the effect and the length of time it takes for a policy variable, such as interest rates to affect credit in the economy and ultimately influence price developments. Overall, it is the degree to which changes in either the cost (interest rate) or the quantity of money affect prices and output, if at all, and the determination of the time lag for the transmission process, that is the perennial challenge and source of variations in policy frameworks.

1.2 Taking these factors into account, since the early 1990s, several central banks in both the developed and emerging market economies have adopted an inflation targeting monetary policy framework in pursuit of price stability. With a primary focus on price stability, the inflation targeting policy regime involves a declaration by the authorities to maintain inflation within a specified range or level, typically by adjusting interest rates. The framework became more popular in the 1990s after it was adopted by the Reserve Bank of New Zealand (1990), Bank of Canada (1991) and Bank of Israel (1991). A similar approach to the conduct of monetary policy is also practiced by, among others, the Bank of England, Sveriges Riksbank, Reserve Bank of Australia, South African Reserve Bank and the central banks of Brazil and Chile. It is also the practice, in all but name, by the European Central Bank. However, it should be recognised that inflation targeting is not universal; most notably, the US Federal Reserve has not adopted it.

1.3 The performance evaluation and record to date indicate that inflation targeting has been largely successful because of, among others, the transparency and the predictability that it provides to the markets, in relation to price developments. The central banks that use inflation targeting emphasise transparency and communication, particularly with respect to the policy framework, objectives and economic forecasts and, by so doing, they influence price and wage-setting behaviour of economic agents to be in line with the price stability objective. This is viewed as enhancing broad macroeconomic stability. In particular, it is argued that the investors' knowledge and appreciation of the central bank's inflation rate target and the possible interest rate path are more easily integrated in their investment choices. Thus, effective control of inflation complements economic growth.

1.4 However, inflation targeting is often criticised for being too mechanical and tantamount to a rule-like approach to policy making; and, in the process, it tends to focus entirely on

controlling inflation at the expense of output and employment. This criticism tends to ignore a consideration that an inflation target is intended to represent a level of inflation that is consistent with a sustainable rate of long-run economic growth and serves as an anchor for inflation expectations. Moreover, there is typically a symmetric response to inflation that is either below or above target, as both these outcomes are deemed to retard economic growth. In addition, the assessment of both the sources of inflation and the reasons for a given level of economic activity allow for a pragmatic approach to policy formulation. This is evidenced by the recent developments when central banks in the US, UK, Canada and Europe kept interest rates unchanged or lowered them in some cases, even though they were exposed to global inflationary pressures due to rising food and energy prices. In fact, in the wake of the 2008 financial crisis and the resultant threat to growth prospects, interest rates were lowered in a number of developed and developing countries, despite residual inflationary conditions. However, this was also in the context of prospects for lower inflation, resulting from the substantial decline in oil prices that started in the second half of 2008.

1.5 An inflation targeting monetary policy framework is premised on a number of prerequisites pertaining to the capability of central banks to independently conduct monetary policy with price stability taking precedence over other policy objectives. Thus, in most of the inflation targeting countries, the government sets the target and provides the central bank the requisite instrument independence to achieve the inflation target. In the circumstances, the macroeconomic policy mix, for example, fiscal and exchange rate policies, should be supportive of the central bank's pursuit of price stability through monetary or interest rate policy.

1.6 This chapter addresses the role of inflation targeting in sustaining price stability and the adaptability of the framework to Botswana conditions. Section 2 outlines, in general, the role and evolution of monetary policy frameworks in controlling inflation. In Section 3, the inflation targeting monetary policy framework is defined and critical pre-requisites are identified, along with an outline of the related benefits and drawbacks. Section 4 deals with inflation performance in inflation targeting countries and provides some background to global price developments generally. Botswana's monetary policy framework is addressed in Section 5 and covers a review of the macroeconomic policy mix, institutional arrangements and operations. In turn, the review in this section explores the extent to which Botswana's system has features of an inflation targeting framework. The conclusion considers the challenges and likely direction of the monetary policy framework going forward.

2. THE EVOLUTION OF MONETARY POLICY FRAMEWORKS

2.1 In broad terms, monetary policy entails the formulation and implementation of strategies aimed at regulating growth of the money supply and/or interest rates to affect economic performance in terms of output growth, inflation, employment and the balance of payments (including trade, capital flows and exchange rate developments). The "quantity theory of money" formulation (equation 1) represents the essence of the role of money growth in determining the combination of output expansion and price developments.

$$MV \equiv PY \qquad (1)$$

In the equation, M is the money stock, V is the income velocity of money,[1] P is the price level, while Y is real output or income. It is an accounting identity, but if assumptions are made about the various components, it

1 In this formulation, the income velocity is the ratio of nominal GDP to the money stock and measures the number of times that money circulates to finance a given level of output; in essence, the rate at which money is exchanged from one transaction to the other during the course of the year in which GDP is generated.

can usefully express differing views about the monetary transmission process. Thus, for example, if M is increased and V is constant, then PY must rise by the same proportion as M; e.g., if M increases by 20 percent and V is constant, then PY must increase by 20 percent, representing the combined effect of increases in both P and Y. If, in turn, the path of Y is also predetermined by other factors, then the only consequence of additional monetary growth is an acceleration in the rate of price increase, i.e., inflation.

2.2 It is the differences in interpretation of this relationship, structural developments and innovations across economies, as well as the quest to assign specific focus for aspects of macroeconomic policy, that have influenced the evolution and transformation of monetary policy frameworks over time and across countries. As indicated by the previous example, the centerpiece of the debate surrounding monetary theory and policy over time has been whether changes in money supply have any effect on real economic variables, such as the output growth rate, the composition of national output and employment, or that it is merely reflected in a change in the price level. The interpretation associated with the Keynesian economics is that an increase in the money stock would generate a real output response because there is scope to increase production in response to the higher demand, while the impact on prices would be smaller.[2] On the right side of equation (1), there is a faster response of the quantity (Y) compared to the price level (P); hence, there is a direct role for monetary policy in fostering long-term growth (an increase in the supply of money will lead to a permanent increase in output). However, where V is not constant, the use of monetary policy would be less predictable in its impact on output.

2.3 Conversely, the monetarist view is that growth in the money stock would simply be reflected in a proportionate increase in prices only, with no effect on output and employment.[3] This conclusion is based on the fundamental assumptions that prices are quick to adjust, while firms are all along producing full employment output. There is, therefore, no scope for a permanent increase in output derived from an increase in money supply; in this model, a higher output is the consequence of structural changes in the economy, including an increase in the factors of production of land, labour and capital, as well as innovation and technological improvements.

2.4 Nevertheless, there appears to be some consensus on there being a short-term stabilisation role for monetary policy. It is considered that, even in the monetarist scenario, full employment output is only a medium- to long-run phenomenon, while contractual obligations and competitiveness can lead to a slow adjustment of prices in the short-run. Therefore, a change in the quantity and/or cost of money can affect output in the short-run and prices will only fully adjust to the change in money supply over the medium-term. Conversely, it is widely acknowledged that in situations of a substantial and possibly prolonged shortfall in aggregate demand, such as in the currently unfolding global economic slowdown, the Keynesian perspective may be the more appropriate guide for policy.

2.5 For example, if the money stock exceeds the demand for money balances, excess cash will be spent on output; while with excess money demand over the money stock, agents will seek to preserve their money balances at the desired level by curtailing expenditure and increasing their savings.[4] The lower demand and expenditure generated by tighter monetary policy (as a result of an increase in interest rates and reduction in the quantity of loanable funds) would consequently result in lower output growth and a slower rate of an

2 Levacic, R. and Rebman, A. (1982), Macroeconomics: An Introduction to Keynesian – Neoclassical Controversies, 2nd ed., Hong Kong, Macmillan.

3 Stevenson, A., Muscatelli, V., and Gregory, M. (1988), Macroeconomic Theory and Stabilisation Policy, New York, Philip Allan.

4 See footnote 2.

increase in prices. Conversely, in the event of slow output expansion, monetary stimulation would increase demand and expenditure, leading to an increase in production to meet the demand, albeit alongside an increase in the price level.

2.6 Overall, there is now an established consensus in macroeconomic policy formulation that money and, therefore, its regulation through monetary policy, is crucial in both stabilising output and mitigating inflationary pressures, thus:

(a) changes in the quantity of money are reflected in prices and/or output;

(b) short-term changes in the economy (output growth) can be the result of, *inter alia*, changes in the quantity of money or in the terms and conditions under which credit was available;

(c) monetary policy can be used for short-term stabilisation of the economy;[5] and

(d) the trend of prices over time reflects the behaviour of the quantity of money.

2.7 The conduct of monetary policy is a function that governments around the world have delegated to central banks. The associated functions of central banks, such as issuance of currency, banker for the banking system and the government and regulation/supervision of banks and the payments system, support the conduct of monetary policy. The policy is conducted within a framework which typically comprises objectives such as price stability and/or output stabilisation, intermediate targets that can be directly affected by the actions of the central bank to influence demand and expenditure decisions, and policy instruments, such as interest rates, which are control levers available to the central bank to influence economic conditions and the intermediate targets.

2.8 The regulation of money supply growth involves various strategies and instruments ranging from direct control of sources of money to indirect or market oriented measures. Direct control strategies include the imposition of limits on levels and growth rates of sources of monetary expansion, among them domestic credit expansion and net foreign assets, as well as direct administrative controls on interest rates and cash, reserve and liquid asset requirements. The market-oriented approach applies a number of instruments aimed at either indirectly influencing changes in market interest rates or reducing the quantity of loanable funds available. Over time, the use of direct controls in this respect has been replaced by indirect measures. This reflects the general trend towards economic and financial liberalisation, as well as the encouragement of competition, enhanced speed of product innovation and expansion of sources of money growth and payment methods, as well as a blurring of roles for various players in the financial sector. The indirect monetary policy instruments that are commonly used include the following:

(a) Policy Interest Rate

2.9 This is the rate of interest at which commercial banks may access credit at the central bank. When the central bank desires to reduce aggregate spending in the economy, it raises the policy interest rate, to which commercial banks respond by increasing their lending interest rates. Increasing the lending interest rate directly raises the cost of borrowing which, in the case of firms, signals the prospect of reduced profitability from investment using borrowed funds; the firms are, therefore, likely to borrow less. In respect of households, there is likely to be an increase in the debt service burden, which should force them to reduce their borrowing and perhaps increase their saving. A reduction in the policy interest rate should have the opposite effect on borrowing and, consequently, aggregate spending in the

5 Friedman, M. (1971), "The Role of Monetary Policy", in Monetary Economics, Readings on Current Issues (Gibson, W.E. and Kaufman, G.G., eds), McGraw-Hill. Though less commonly accepted, the Friedman exposition suggests that monetary policy is the primary instrument available for stabilising the economy.

economy. However, it should be appreciated that the policy rate is only one factor, among several, that influences the overall cost and quantum of borrowing.

(b) Open Market Operations

2.10 Open market operations (OMOs) involve the purchase and sale of securities by a central bank. When a central bank purchases securities, more money is injected into the banking system, as holders of securities receive funds which they deposit into their bank accounts. As a result, deposits at commercial banks increase with the effect of increasing money supply and lowering interest rates. In the case of the sale of securities by a central bank, the buyers' deposits at commercial banks decrease, thus lowering money supply and raising interest rates; for a given level of money demand, a reduction in money supply would result in an increase in interest rates.

(c) Statutory Reserve Ratio

2.11 This instrument requires commercial banks to hold a certain proportion of their deposit liabilities in an account at the central bank.[6] This constrains the lending ability of commercial banks, as these funds are not available for lending. When the central bank increases this ratio, commercial banks have less funds to lend, which leads to a reduction in the amount of deposits created (money supply) and spending potential. Conversely, a reduction in the ratio increases commercial banks' funds available for lending, which has the effect of raising the amount of deposits created and, therefore, money supply.

(d) Moral Suasion and Communication Strategy

2.12 Even in the absence of changes in any of the instruments identified above, the central bank can communicate directly with commercial banks to instigate a shift in the policy stance or to secure the desired market response. This is particularly important for magnifying the more direct control over short term interest rates into longer maturities. In addition, central bank transparency and communication is increasingly used to influence inflation expectations and, therefore, economic decisions. It is notable, for example, that many central banks not only disseminate their policy framework, they also communicate policy decisions and the rationale for them, even in instances where there have been no changes to the policy instruments. It is also common for such announcements to include indications of the expected future direction of policy: for example, whether interest rates are likely to increase or decrease. In the currently prevailing global economic turmoil, effective communication by central banks has been especially important in supporting the effectiveness of monetary policy at a time when the likely impact of interest rate movements has become less certain.

2.13 Identification of an intermediate target, a variable that links the instrument to the ultimate objective, is another common element of a monetary policy framework. The use of intermediate targets in conducting monetary policy is necessitated by uncertainties inherent in the economic environment.[7] In particular, to serve a useful purpose, intermediate targets must have certain properties which include being amenable to control by the available policy instruments in use, a stable relationship with the ultimate objective and regular and timely availability of information about their behaviour. By focussing on an intermediate target variable, monetary authorities can identify both its response to the policy instrument(s) being deployed and its potential impact on the ultimate objective; and, in turn, this allows for pre-emptive policy action (realignment of the instrument) to influence the ultimate target in the desired manner. In essence, this describes the monetary policy transmission mechanism or process and

6 In many instances, like in Botswana, this would be a non-interest bearing account.

7 Stevenson, A., Muscatelli, V., and Gregory, M. (1988), Macroeconomic Theory and Stabilisation Policy, New York, Philip Allan.

reflects the view of the authorities (ideally statistically determined) about the quantitative and dynamic (time lag) relationship between the instruments, intermediate target and ultimate target. Therefore, to the extent that the application of monetary policy instruments is intended to affect, in a predictable manner, some defined ultimate objective such as price stability, a proper understanding of the policy transmission mechanism is a crucial consideration in the design of the monetary policy framework. As indicated above, the level and nature of economic and financial developments, as well as country peculiarities, determine the choice of a monetary policy framework, among which are money targeting, exchange rate targeting, and inflation targeting.

Monetary Targeting

2.14 The monetary targeting approach is premised on the desire to regulate the growth of money at a level that is consistent with the price stability objective; a desirable level of inflation that does not undermine long-run output growth. The approach also involves a determination of a monetary aggregate or definition of money to use as the intermediate variable over which a growth target is set. The definition of the monetary aggregate can range from a narrow focus on cash, or base money, to the inclusion of a wide range of bank deposits of varying maturities. The instruments used in monetary targeting include the traditional open market operations, short-term interest rates and reserve requirements. This framework provides a clear operational guidance for day-to-day policy making, thus reducing policy discretion while ensuring that the rate of increase for the indicative money aggregate remains on a pre-determined path. Significantly, the framework assumes a stable and well-understood relationship between inflation/output growth and the targeted monetary aggregate, while the growth path for the relevant aggregate is verifiable, with a reasonably short lag.

2.15 However, experience has consistently shown that the relationship between money growth and inflation was unstable and unreliable, particularly in the context of financial innovation, greater use of new technology in payments and global accessibility of finance. Monetary targeting was, therefore, abandoned in several countries from the early 1980s onwards, although notably remaining in use in countries such as Germany (and subsequently the euro zone) and Switzerland. In Africa, countries that continue to use monetary targets include Malawi, Tanzania and Zambia.[8]

Exchange Rate Targeting

2.16 Under the exchange rate targeting regime, the value of a country's currency is fixed to that of a low-inflation trading partner. Thus, this approach is more common with low and middle-income countries that may lack policy credibility and/or nations that are in a common economic regional grouping. Conversely, it is clearly not suitable for larger economies, such as the US or Japan, which could not expect a sufficiently strong controlling influence from a smaller anchor. Worldwide, some form of exchange rate targeting remains the predominant framework: as of April 2007, out of 188 countries surveyed by the IMF, 105 maintained some form of explicit currency peg.

2.17 Among the important challenges in this framework are those relating to the choice of foreign currency to peg to and whether to fix to a single or combination of currencies. In general, the choice of a currency to peg to is informed by proximity, importance in trade and convertibility or usage in international transactions, as well as (ideally) whether the anchor country has a successful track record in controlling inflation. The preference for a basket involving more than one currency recognises the diversity of trade relationships (and the variety of currencies used in

8 One reason for continuing to use monetary targets in developing countries is the timely availability of data necessary to monitor the target.

BOX 2.1: EXPERIENCE OF MONETARY TARGETING IN SELECTED COUNTRIES

Monetary targeting was first introduced in the United Kingdom *in 1973 in response to concerns about rising inflation. However, this was not pursued vigorously until 1979, when a new government, more fully committed to monetarism, was elected. In order to achieve the gradual reduction of inflation, which had accelerated in the late 1970s, a Medium-Term Financial Strategy was adopted, which proposed a steady reduction in the growth of sterling M3 (the monetary aggregate that was targeted). However, while the tightening of monetary policy had a severe impact on output and, ultimately inflation, monetary growth continued to exceed the target. As a result, the relationship between sterling M3 and national income came under increasing scrutiny which, in turn, raised doubts about the effectiveness of using monetary targets as a means of achieving price stability. In response, the authorities began to de-emphasise M3, first introducing both broader and narrower additional targets, before finally abandoning monetary targets in favour of a greater focus on the exchange rate where shadowing the value of the German deutschemark was used as an informal way to benefit from the discipline of the European Monetary System. A formal exchange rate targeting policy was not followed until 1990, due to disagreement among country authorities.*

In Canada*, monetary gradualism, in which growth of M1 (narrow money) was kept within a gradually declining target range, was introduced in 1975 to support the Anti-Inflation Programme, which also included a range of direct controls on prices and wages with a view to bringing inflation down while not undermining economic growth. However, use of a narrow measure of money proved unreliable as a guide for inflationary trends, while monetary restraint was undermined by expansionary fiscal policy. Inflation was reduced significantly after the introduction of non-gradual approach to policy tightening, as the Bank of Canada matched interest rate increases in the United States; however, this came at the expense of a severe recession in the early 1980s; and given concerns for the exchange rate and the uncertainty about M1 being a reliable guide to monetary policy, the Bank of Canada discontinued monetary targets in 1982.*

During the 1970s the US Federal Reserve (Fed) was required to announce regular targets for broad money. However, the commitment to meet these targets was lacking, as greater weight was given to using monetary policy in support of expansionary fiscal policy to promote growth and employment. In turn, this reflected both the Fed's broader mandate to pursue other objectives in addition to price stability, together with a lack of consensus over the effectiveness of monetary policy, with direct (incomes policy) measures to control wage and other price increases being a preferred method to tackle inflation. With the support of a new administration, the resulting build-up in inflation that had occurred in the previous decade was effectively tackled in the early 1980s through rigorous adherence to monetary targeting. However, a combination of sharply higher interest rates and entrenched expectations of sustained inflation meant that the cost in terms of unemployment was high. With the rate of price changes brought under control, including inflation expectations, policy became more pragmatic from 1982, with more attention once again given to using less tight monetary conditions to help support GDP growth. In 1987, the monetary targets were abandoned on the basis that they were confusing. Since then, the Fed has employed a discretionary policy which allows for pursuit of wider objectives, while maintaining public confidence that inflation will not be allowed to again get out of control.

In Germany and Japan*, the experience of monetary targeting in the 1970s and 1980s was generally more positive. The Bank of Japan was successful in bringing inflation down with less variability in both money supply and output than in the US, largely because of a clear indication of its commitment to the policy. From the mid-1990s, however, when deflationary conditions have largely prevailed and the intermediation function of the financial institutions has been impaired, the utility of monetary aggregates has declined. Nevertheless, the Bank of Japan retained its focus on influencing monetary expansion through a programme of "quantitative easing" in the context of near-zero nominal interest rates. The European Central Bank (ECB) continues to maintain explicit monetary targets as a direct legacy of the German Bundesbank, which never abandoned their use and played a central role in the establishment of the ECB. A key feature of the application of monetary targets in Germany was their pragmatic use as a tool for monitoring and communication, rather than as a yardstick for policy.*

international transactions and payments), as well as the need to moderate the impact of fluctuations of any one currency or economic developments in any one country.

2.18 The rationale for an exchange rate targeting system is to anchor domestic inflation on a foreign country's low inflation and import its monetary policy credibility. The policy instruments in this framework include interest rates and foreign exchange interventions. The target exchange rate may be defined as a fixed rate, one with a constant rate of adjustment or one with responsive discrete adjustments. To maintain the desired official parity, the central bank commits itself to managing the demand and supply of foreign exchange, which inevitably requires the country to hold

a sufficient level of international reserves to be able to intervene in the foreign exchange market for its currency.[9] In this exchange rate system, monetary and fiscal policies are conducted in a manner that supports the target exchange rate. Changes in interest rates are effected to sustain the par value or parity, as a result of which monetary policy is subordinated to the exchange rate policy. Thus, the independence of monetary policy is relinquished in an environment of a fixed exchange rate regime as policy is unable to respond to developments in the domestic economy that are not present in the country to which the currency is pegged.

2.19 In its extreme form, exchange rate targeting can be a currency board, which is an arrangement under which a country fixes its exchange rate and maintains 100 percent backing of its money supply with foreign exchange.[10] The board represents a country's monetary authority that issues notes and coin, while the instrument of monetary policy is the exchange rate, with price stability being the ultimate target. The exchange rate is strictly fixed, since the currency board issues local notes and coin in circulation that are anchored on a foreign currency, usually a strong internationally-traded currency, to which the value and stability of the local currency is directly linked.

2.20 Another extreme outcome of exchange rate targeting is a monetary union, where a group of countries share a single currency with a single monetary authority conducting a common monetary policy for the union as a whole. The European Monetary Union (EMU), where the euro is the currency circulating in the member states, exemplifies this form of arrangement. If the countries involved had initially used separate currencies, the final step to a monetary union is preceded by a period when the exchange rates have been increasingly closely aligned. The EMU evolved from the European Monetary System (EMS) (also a form of exchange rate targeting) which started in 1979; each participating country determined a central exchange rate for its currency against the European Currency Unit (ECU), which was the accounting unit of the then European Community. The euro was launched for accounting purposes in 1999, and notes and coin were not issued until 2002.

2.21 In the Southern Africa region, fixed exchange rates are also used in the Common Monetary Area (CMA). The CMA (formerly the Rand Monetary Area) comprises Lesotho, Namibia, South Africa and Swaziland, with the three smaller economies pegging their local currencies at par (one-to-one) to the South African rand. This is in recognition of the substantial level of economic integration with their large neighbour (the rand circulates freely in all three countries), as well as the anticipated benefit of low inflation in South Africa. Effectively, these countries have surrendered the conduct of their monetary policies to the anchor country, while fiscal policy developments in South Africa also impact on their economies.

2.22 As well as these formal arrangements, many countries have continued to maintain exchange rate targets of varying degrees of formality. In the early 1980s, while notionally committed to monetary targeting, Canada benefited from the anti-inflation policy in the US by adopting an implicit inflation target; and later in the same decade, the United Kingdom, where there was political opposition to a more formal arrangement, informally shadowed the German deutschemark as a proxy for participation in the EMS. More recently, Denmark has chosen to link the domestic currency to the euro in practice, while opting to retain its formal monetary independence.

3. INFLATION TARGETING

3.1 The inflation targeting monetary policy framework emanates from a desire to afford a single focus or, at least, to clearly specify

9 Chacholiades, M. (1990), International Economics, New York, McGraw-Hill International edition.

10 Williamson, J. (1995), http://www.iie.com/PRESS/cboard.htm, 12/09/08

a measurable priority objective for monetary policy and, in turn, a reference yardstick to hold the responsible authority accountable. As highlighted above, central banks have previously relied on the alternatives of targeting monetary aggregates or exchange rate targets to stabilise inflation, while at the same time there was short-term manipulation of monetary policy to achieve other goals, such as higher levels of employment and enhanced output growth. However, attempting to achieve these other goals can give monetary policy an inflationary bias. Central banks appear to get more criticism from raising interest rates than from lowering them; in turn, this reflects greater immediate concerns for maintaining or accelerating output growth, especially in the short-term when the negative consequences of losing control of inflation may not be so readily apparent. By making inflation the primary goal, an inflation targeting framework helps to address this asymmetry. Moreover, for several countries, the adoption of an inflation targeting regime was in the context of a previously poor record of fighting inflation, where the monetary authorities were perceived as lacking credibility.

3.2 The framework, therefore, entails a numerical definition of price stability, in terms of the desired level of inflation, and to which, for monetary policy purposes, other economic objectives are subordinated. However, there is no suggestion that other economic and social goals are less important. Rather, it is considered that the use of monetary policy to achieve the defined level of price stability is a more optimal approach to supporting and facilitating the achievement of that objective and, in broad terms, the objectives of sustainable long-run economic growth, high levels of employment and the upliftment of living standards.

3.3 An inflation targeting monetary policy framework is forward-looking, giving the central bank an opportunity to adjust policy proactively to maintain inflation at the targeted level over the medium-term. In practice, this has three elements: the central bank forecasts the future path of inflation; the forecast is compared with the target; and the difference between the forecast and the target determines the quantum of monetary policy adjustment required. Beyond this, there are essential institutional, capacity and technical requirements that are necessary for a successful operation of an inflation targeting regime. The experience of industrial countries that have adopted inflation targeting suggests that the foundations for a successful inflation targeting regime are the following: a sound fiscal position and entrenched macroeconomic stability; a well-developed financial system; central bank instrument independence and a clear mandate to achieve price stability; a reasonably well-understood transmission mechanism between monetary policy and inflation and a sound methodology for constructing inflation forecasts; and transparency of monetary policy to build accountability and credibility.[11]

Prerequisites and Preconditions for Inflation Targeting Monetary Policy Framework

(a) Single Objective of Price stability

3.4 To conduct a full-fledged inflation targeting monetary policy framework, the central bank should have a mandate to pursue an inflation objective/target for which it is accountable and which should not be subordinated to other objectives. Indeed all inflation targeting countries specify price stability as the single policy objective. In particular, the inflation target takes precedence over an exchange rate objective. The central bank should not target both inflation and the nominal exchange rate in an attempt to influence the exchange rate, even in the presence of competitiveness concerns or current account pressures. It is argued that adjustments needed to correct the

11 Carare, A., Schaechter, A., Stone, M.R., and Zelmer, M., "Adopting inflation targeting: Practical issues for emerging market countries." IMF Working Paper, June 2002.

external position are best dealt with through fiscal policy or structural policies that address capacity and productivity issues.

3.5 However, it is accepted that small, open economies, especially those with thin or uneven foreign exchange markets may need the central bank to intervene or adjust interest rates to limit the effect of temporary exchange rate shocks on inflation and financial stability. Although rare with respect to industrial countries, in practice, inflation-targeting central banks have an option to intervene in the foreign exchange markets. In such instances, it is considered useful to have a transparent framework that reassures the market that policies aimed at influencing the exchange rate are intended solely to limit its impact on inflation and maintain financial stability, as opposed to pursuing an exchange rate objective.

(b) Absence of Fiscal Dominance

3.6 Apart from eliminating the explicit reference to the goal of stimulating economic activity, an inflation targeting regime also requires the absence of fiscal dominance. The weight of public borrowing requirements within the financial system should be limited in the sense that its financing needs do not overwhelm other policy considerations. In particular, this requires that direct borrowing of the public sector from the central bank should be controlled, with limited reliance on seigniorage[12] by the government. It is also important that there should be no political pressure on the central bank to finance the government budget or a requirement to maintain low interest rates on public debt. Another area of relevance is coordination of debt management and fiscal and monetary policies, where there is need to clarify the roles and objectives of debt management and monetary policy so as to minimise potential conflicts. In particular, it is also suggested that, as emerging market inflation-targeting countries develop market-based monetary instruments, they should promote a separation of monetary policy instruments from debt management by having the central bank operate in the secondary market to manage its balance sheet, rather than using the primary market.[13]

(c) Setting the Inflation Target: Goal or Instrument Independence for the Central Bank

3.7 A distinction is made between goal independence and instrument independence of the central bank. In the case of goal independence, the central bank sets the inflation target (ostensibly in line with the price stability objective provided by legislation), while in the case of instrument independence, the government determines the inflation target and the central bank is given operational independence to achieve the inflation target. Often central bank legislation states the primary objective of monetary policy in rather vague terms, such as the pursuance of 'domestic price stability', while the setting of an explicit inflation target is done separately, mostly through a publicly-announced agreement between the government and the central bank. This approach recognises the fact that monetary frameworks evolve over time, and helps to limit the number of legislative amendments that might otherwise be required. Nevertheless, even in instances where the central bank legislation does not explicitly mention an inflation target, the target has been justified as an operational interpretation of the ultimate goal of currency or price stability.[14]

12 Seigniorage is the difference between the face value of currency issued and the cost of its production, distributing and eventually removing it from circulation. Since a government can, whenever needed, print money, seigniorage can be a cheap source of deficit financing. It is referred to as an inflation tax, since it can be used, in lieu of tax increases. The resultant expansion of the money supply raises inflation, which reduces the real value of the currency held by the public, which is equivalent to taxing holders of the currency.

13 *Op. cit.*

14 While there is some ambiguity about the meaning of "currency stability" in practice, it is generally interpreted to be synonymous with price stability and does not imply exchange rate targeting.

TABLE 2.1: ANNOUNCEMENT OF INFLATION TARGETS

Target announced by	Countries
Government	Brazil, Iceland, Israel, Norway, United Kingdom
Central bank	Chile, Colombia, Mexico, Poland, Sweden, Thailand
Jointly by government and central bank	Australia, Canada, Czech Republic, Hungary, South Korea, New Zealand, South Africa

Source: Central bank websites

Moreover, given that inflation targeting precludes fiscal dominance, several countries explicitly limit or do not allow central bank financing of the government deficit. Tables 2.1 and 2.2 summarise the practice in inflation targeting countries.

(d) Price Index

3.8 As described in Section 2, monetary policy is generally designed to affect aggregate demand through its influence on the cost and availability of loanable funds. Thus, monetary policy should not ordinarily respond immediately to price developments that are due to supply side transitory factors, for example, discrete adjustment of administered prices, price movements with a monetary policy reference (e.g., changes in mortgage interest rates) and price increases due to changes in the tax system. Therefore, in an inflation targeting regime, the authorities often have to choose a price index, other than the published overall index, so as to target an inflation rate to which monetary policy has a proximate effect. Nevertheless, to sustain transparency and credibility, it is important to use a representative price index that is widely understood. Apart from choosing the price index, the following choices or steps have to be taken:

(a) setting the target in terms of either the price level or the rate of inflation;

(b) giving the target a numerical value;

(c) deciding whether to define the target as a point or band;

TABLE 2.2: CENTRAL BANK LEGAL FRAMEWORKS

Central Bank Legal Framework	Countries
Objectives of monetary policy	
Domestic price stability as primary objective	Colombia, Czech Republic, Hungary, Iceland, Korea, Mexico, New Zealand, Norway, Poland, Spain, South Africa, Sweden, Thailand, United Kingdom
Currency stability as primary objective	Finland, Norway
Currency stability plus other objectives	Brazil, Australia, Canada, Chile, Israel
Instrument independence	Austria, Brazil, Canada, Chile, Colombia, Czech Republic, Finland, Hungary, Iceland, Israel, Korea, Mexico, Poland, New Zealand, Norway, South Africa, Spain, Sweden, Thailand, United Kingdom
Financing of government deficits	
Limited	Canada, Colombia, Czech Republic, Korea, Mexico, Norway, South Africa, Thailand
Not allowed	Brazil, Chile, Finland, Hungary, Iceland, Poland, Spain, Sweden

Source: Central bank legislation, central bank annual reports and inflation reports

(d) setting the time horizon of the target; and

(e) determining the possible escape clauses or exemptions to the inflation target under specific circumstances.

3.9 The target inflation rate can be specified either as a range (such as the South African Reserve Bank's 3 – 6 percent), a point target with a range (such as a 2 percent target with a range/tolerance interval of plus/minus one percentage points, such as in Canada and Sweden); or as a point target without an explicit range (such as Norway's 2.5 percent).[15] In a number of developed countries, the inflation target centres around 2 percent in recognition of the fact that there are biases in the calculation of the consumer price index, for example, due to the introduction of new goods,

15 Svensson, L. E. O., (2007), "Inflation targeting", *The New Palgrave Dictionary of Economics,* 2nd edition.

quality improvements and higher demand for better quality goods. The implication of this is that, in practice, price stability is likely to be associated with a small positive rate of consumer price inflation rather than with a zero rate. A band, on the other hand, recognises that monetary policy has an imperfect control of inflation. While a narrow band indicates a stronger commitment to the inflation target, it is more likely that it would be difficult to remain within it and this means that breaches could undermine credibility. The distinction between these choices is, nevertheless, blurred because some central banks that specify their targets as a range may aim for the mid-point, while others may be biased towards operating at the edges of the band.

3.10 The target horizon defines the period within which the central bank commits itself to achieving the targeted inflation rate. The horizon may be short or long depending on the assessed monetary policy transmission mechanism. This also depends on the level of current inflation relative to the long-run rate (target) and the desired disinflation trajectory. Short-term target horizons and lead times may result in instrument instability, particularly if the horizon is shorter than the policy lags. However, if inflation is above the long run rate, shorter horizons could speed up the disinflation process. On the other hand, long-term horizons afford the central bank greater scope to respond to shocks, which can help to consolidate inflationary expectations towards the inflation target and minimise the output loss associated with rapid adjustment. A number of emerging market economies determine their disinflation path through setting annual targets and a long-run objective. In almost all developed economies and most emerging market economies, the attainment of price stability is assessed over a rolling medium-term policy horizon. Table 2.3 summarises the practice in the inflation targeting countries.

3.11 In several inflation targeting countries with instrument independence, the legislation or central bank mandate provides for escape clauses which define circumstances in which inflation targets breaches may be tolerated. Only a few countries have escape clauses which are intended to enhance flexibility.[16] However, the extent of breach tolerance inevitably involves a trade-off between flexibility and credibility. Escape clauses set out in advance conditions in which targets may be missed and, in turn, the expected response by the central bank. The central bank may be required to indicate the time frame for its attempt to return to the inflation target or communicate a new target in case a revision has been deemed necessary. The disadvantage of escape clauses is their largely discretionary application and failure to capture all potential

TABLE 2.3: INFLATION TARGET DESIGN – COUNTRY EXPERIENCES

Price index	Countries
Consumer Price Index	Australia, Brazil, Canada, Chile, Colombia, Hungary, Czech Republic, Finland, Israel, Korea, Mexico, New Zealand, Norway, Poland, Spain, Sweden, Peru, Philippines, Ghana
Core/Underlying CPI	South Africa, Thailand, United Kingdom, Iceland
Point Target or Target Range	
Point target	Colombia, Finland, Mexico, Norway, Spain, United Kingdom, Brazil, Hungary, Iceland, Sweden, Poland, Peru, Slovak Republic, Indonesia, Romania, Ghana
Target range	Australia, Canada, Chile, Czech Republic, Israel, New Zealand, South Africa, Thailand, Korea, Philippines
Target Horizon for Inflation Targets	
Annual targets	Korea, Mexico, South Africa, Brazil, Colombia, Czech Republic, Hungary, Spain, Philippines, Ghana, Slovak Republic
Rolling medium-term horizon	Australia, Canada, Chile, Finland, Iceland, Israel, New Zealand, Norway, Sweden, United Kingdom, Thailand, Peru, Poland

Source: Bernanke, B.S., Laubach, T, Mishkin F.S., and Posen, A.S. (1999), "Inflation Targeting: Lessons from the International Experience", Princeton University Press; Central bank websites.

16 These include Canada, Czech Republic, New Zealand, South Africa and, in some respects, the United Kingdom.

shocks. As such, use of these clauses in situations that are not clearly defined might erode the accountability and credibility of the inflation targeting framework.

(e) Modelling and Forecasting Capability

3.12 The importance of inflation forecasting derives from the fact that forecasts systematically guide the response of monetary policy. The inflation forecast in an inflation targeting framework can be considered the intermediate policy target, since, in practice, the policy stance is adjusted whenever there is evidence that future inflation might differ persistently from the target path. Therefore, an inflation targeting policy regime requires a rigorous modelling of the economy and forecasting capability that incorporates technical data, sound and consistent analysis and policy makers' intuitive and analytical judgements. In essence, the central bank's inflation forecast should make use of all available information on the outlook for inflation. To enable credible modelling and forecasting, it is critical that the structure of the economy must be reasonably stable and easily modelled to ensure an accurate forecast. This implies that there should be sufficient historical data to establish reliable relationships and there should be reasonable confidence that these relationships will remain stable under the envisaged regime. In order to broaden the set of information, inflation-targeting countries typically use inputs from several different models, while it is also recognised that models can never replace judgement by the policymakers and that discretion will always play a role in determining policy. Models, nevertheless, are considered to be a tangible representation of the monetary policy framework and the accepted view of the policy transmission process; hence, they facilitate a disciplined, coherent and consistent policy analysis.

(f) Developed and Stable Financial System

3.13 Well-functioning, deep and liquid financial markets are more supportive of an inflation-targeting monetary policy framework, as they facilitate the use of market-based instruments and enable effective policy transmission. The effectiveness of the policy framework is enhanced because deep and liquid financial markets ensure that movements in market interest rates and other asset prices convey information to the central bank on economic fundamentals and market expectations regarding future monetary actions. Moreover, a healthy financial system implies that there is limited vulnerability to crises and bolsters the credibility of monetary policy (at least until the recent financial turmoil), thereby helping to anchor inflation expectations to the target level.

3.14 It is important that the conduct of monetary policy is not constrained by concerns about the health of the financial system. There should be minimal risks of financial sector disturbances that cloud the public's ability to interpret the stance of monetary policy, while operations and policy transmission and effectiveness are not complicated by weaknesses in financial markets infrastructure. Deep and liquid financial markets are able to absorb shocks, thus allowing the central bank to focus on the inflation target, as opposed to minimising the impact of short-term shocks or acting to preserve financial stability. Monetary policy is constrained if an increase in interest rates needed to tighten monetary conditions threatens the health of "systemically" important financial institutions or markets.

3.15 The financial turmoil that started in September 2008 demonstrates the effect of the breakdown in the transmission process on the ability to conduct monetary policy, with respect to both price and output stabilisation. In an environment of constrained inter-bank financial flows and credit extension to other sectors, the link between the conduct of monetary policy and economic activity is severely hampered. Moreover, the desire to prevent a collapse of the financial system renders the conduct of normal open market operations impossible, as central bank liquidity support is focused

solely on funding the banking system. The response by the authorities generally reflects the theoretical and conceptual points addressed at Sections 2 and 3 above that recognise that the financial system plays a key role as the conduit for the transmission of macroeconomic policy (in particular, monetary policy); that the price stability objective is set with a view to the long-run trend for output growth; and that there is a role for fiscal policy in output stabilisation (the Keynesian response). Specifically, therefore, the authorities have responded to the financial crisis in the following manner:

(a) a generalised protection of the financial system from collapse, not only to protect depositors and investors, but to ensure its continuing role in financing the real economy and facilitating payments;

(b) expansionary monetary policy involving a decrease in interest rates and injection of liquidity into the banking sector, in the context of expectations of future low inflation, partly due to subdued growth and recession in some instances; and

(c) fiscal support and tax reductions, including direct funding of the financial and other sectors of the economy.

(g) Accountability and Transparency

3.16 In practice, inflation targeting central banks often operate independently, but they are formally accountable to the government and are required to submit or publish specified reports. An inflation target provides a yardstick against which central bank monetary policy actions can be judged and any announcement of a policy change is accompanied by an explicit explanation of the reason for the change. Transparency has a real effect, in that it reinforces the impact, as well as reduces the lag of the effect of monetary policy on price and wage decisions. Accountability is essential in an inflation-targeting framework because policy transmission lags make it difficult for the public to monitor policy performance on an on-going basis, by observing only the current level of inflation. Transparency includes explicit and publicly stated targets; a clear understanding by the public of the principal monetary policy operations; and recognition that changes in monetary policy should be accompanied by explanations of factors that motivated changes. Being transparent also involves the authorities signalling expected breaches of a target ahead of time and the actions the central bank is taking to address the breaches, as well as *ex post* assessment of monetary policy performance.

3.17 Table 2.4 below summarises the prerequisites for an inflation targeting monetary policy framework in terms of institutional and economic preconditions.

Advantages of Inflation Targeting

3.18 Inflation targeting is operated in several developed and developing economies and followed dissatisfaction with the performance of the alternative monetary policy regimes.

TABLE 2.4: INFLATION TARGETING PRECONDITIONS

INSTITUTIONAL PRECONDITIONS	ECONOMIC PRECONDITIONS
• Instrumental independence	• Appropriate price index
• Effective monetary policy instrument	• Width and horizon of inflation target
• Accountability	• Adequate knowledge of transmission mechanism of the monetary policy
• Transparency/disclosure	
• Well developed financial sector	• Availability of inflation forecast
• Flexible exchange rate regime	• Adequate measurement and well-timed economic information
• Public support	
• Harmony with fiscal policy	
• Sole target	

Source: Bernanke, B.S., Laubach, T., Mishkin, F.S., and Posen, A.S. (1999), "Inflation Targeting: Lessons from the International Experience", Princeton University Press.

In particular, the alleviation of uncertainty and instability of the relationship between important variables in a monetary targeting policy framework. Other countries also sought to get away from the constraints of the exchange rate targeting framework, which tends to limit the pursuit of an independent monetary policy consistent with conditions in the domestic economy; while others needed a base on which to establish previously lacking credibility.

3.19 The inflation targeting framework has the advantage that the announcement of an explicit inflation target provides the central bank with a clear objective and precise definition of price stability. For several countries, previous attempts at pursuing multiple objectives have resulted in ineffective monetary policy, especially in situations of limited credibility of a central bank or a government bias towards expansionary policy. The pressure to achieve lower unemployment rates through expansionary monetary policies often resulted in high average inflation, but without leading to any sustained boost to employment and growth. Policy formulation towards a government mandated and explicit inflation target is, presumably, insulated from such political pressures. Overall, the inflation targeting regime has the advantage of focusing the political debate on what the central bank can do in the long run, i.e., control inflation, rather than what it cannot do (raise output growth, lower unemployment, increase external competitiveness) through monetary policy.[17]

3.20 In the absence of these pressures, the framework enhances the central bank's credibility in maintaining stable and low inflation over the long run. In turn, it helps sustain and anchor inflation expectations in the economy as it allows businesses and individuals to be informed about future inflation when making investment decisions, as well as planning for the future. The inflation targeting framework thus helps project a clearer path for the medium-term inflation outlook and, as a result, it reduces the extent of inflation surprises and associated implications. In the long term, interest rates fluctuate with movements in inflation expectations; so targeting and attaining a low and stable rate of inflation would result in more stable and lower long-term interest rates that are more conducive and less costly for investors. Moreover, the associated reduction in uncertainty is beneficial for long-term stability and development of both the financial and capital markets and also better informs the processes of price and wage setting.

3.21 The inflation targeting regime also facilitates better cyclical adjustments of the economy, given the scope for discretion and flexibility in dealing with aggregate demand and supply shocks. In addition, the focus on the final objective minimises frequent adjustments. In contrast, a monetary targeting framework may require periodic adjustment of the monetary growth target to account for shifts in the money demand function, resulting in changes in the relationship between monetary growth and the price stability goal of the central bank.

3.22 Inflation targeting also provides a clear yardstick through which the efficacy of monetary policy can be measured. By comparing inflation forecasts with the announced target, judgement can be made about the appropriateness of the current monetary policy stance, while the overall inflation performance and contribution to macroeconomic stability would indicate the efficacy of the monetary policy framework. With increased transparency, the private sector and the public are able to monitor and evaluate the authorities' advice and analysis, as well as actions, which help to sustain discipline and competency in policy formulation.

Disadvantages of Inflation Targeting

3.23 It can be argued, in terms of the drawbacks of an inflation targeting regime, that the sole focus

17 Mishkin, F. S., (2000), "Inflation Targeting in Emerging Market Countries", American Economic Review, Papers and Proceedings, Vol. 90, No.2, pp 105-109.

on a numerical inflation objective (even with some escape clauses) and a consistent response to the inflation forecast reduces flexibility and discretion in monetary policy formulation. In the circumstances, the alignment to other policy goals and development concerns may be hampered. At the same time, the forward-looking approach inherent in this framework introduces additional uncertainties in the policy formulation process, thereby permitting more discretion on the part of the monetary authorities. Such discretion might be inconsistent with both the fundamentals and the policy transmission process implied by the framework.

3.24 It is also observed that the focus on achieving and maintaining low inflation as the sole objective of the central bank tends to obscure other macroeconomic policy goals. The point is that, just as uncertainty about inflation impedes sound economic decision making by economic agents, so does uncertainty regarding the future level of output and employment. Arguably, inflation targeting tends to ignore output and employment and, given the multiple goals of macroeconomic policy, the single focus on inflation under an inflation targeting regime does not enhance the overall transparency of the monetary authorities in relation to other macroeconomic policy goals.

3.25 For most developing countries, the adoption of inflation targeting may prove very difficult due to heavy government reliance on seigniorage, shallow financial markets, and fragile banking systems. In developing countries, the link between the government's inability to raise revenue from conventional sources (due to unstable sources of tax revenue, poor tax collection procedures and a skewed income distribution) and the recourse to seigniorage is very high, particularly at times of crises. Moreover, developing countries often have difficulties dealing with relatively high inflation rates, and tend to have large forecast errors resulting in frequent missing of targets. In these circumstances, the central bank may have difficulties in explaining persistent deviations from the target; in turn, this will make it difficult for the central bank to gain and enhance credibility that is very crucial under inflation targeting, while the transparency objective will also be undermined.

3.26 One of the pre-requisites for inflation targeting is that the exchange rate should be flexible, which may cause financial instability in developing countries. A freely floating exchange rate may result in volatility that is detrimental for a developing country; real appreciations might hinder the competitiveness of exports, while depreciation can adversely affect the soundness of domestic companies, if their debt is denominated in foreign currency.

3.27 Notwithstanding the possible drawbacks indicated above, in practice monetary policy formulation involves significant consideration of output trends, coordination and assessment of the macroeconomic policy mix and its impact on broad economic goals. Moreover, the price stability objective is determined as a level that is consistent with long-run potential output growth and is also supportive of external competitiveness, while it engenders productivity improvements. Lower inflation relative to that prevailing in other countries contributes to a lowering of domestic production costs and mark-ups; increases in profits and incomes are then derived from productivity improvements for both firms and labour.

4. INFLATION PERFORMANCE UNDER INFLATION TARGETING

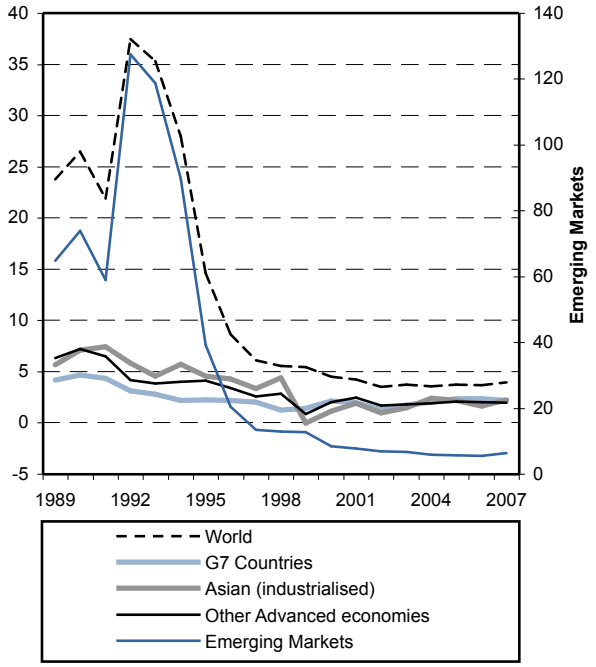
4.1 The global inflation performance that coincided with widespread adoption of the inflation targeting monetary policy framework from the 1990s has generally been positive, with a general decline in the rate of price increases across several countries (Chart 2.1). For the inflation targeting countries, the decline in inflation could, to a large extent, be attributed to this framework. The commitment by the respective governments and the enhanced

monetary policy focus on the single objective of price stability focussed central bank resources on this objective, particularly with respect to policy deliberations, determination of the policy transmission mechanism and inflation forecasting, as well as the communication strategies. To the extent that these factors engendered integrity of the framework, it also influenced expectations and the confidence that the central bank will always act to achieve price stability. With inflation expectations anchored around the inflation target or objective, there has been a tendency for actual inflation not to deviate much from this level. The effect of exceptional supply-side influences also tended to be transitory and not entrenched.

4.2 It can also be argued that low inflation in several countries would also be transmitted to other economies, leading to a greater role of productivity improvements in profit and income growth. The other perspective is that productivity improvements over the period also contributed to a reduction in the rate of price increases. In this respect, enhanced productivity is associated with changes in production processes and logistics by major international corporations, greater competition and innovations around information and communications technology. Notable developments include the transfer of production to low cost centres and, in turn, enhanced growth potential in such economies. Meanwhile, improvements in information and communications technology, in addition to supporting outsourcing and competitive production, led to improvements in services, low unit costs and enhanced international access to goods and services by consumers.

4.3 Overall, the greater efficacy of monetary policy was also in the context of a conducive environment of low rates of price increases and quality improvements in both goods and services. The inflation performance, therefore, in the last two decades appears not to differ much between the inflation targeters and the non-targeters. However, as indicated above,

CHART 2.1: WORLD REGIONS AVERAGE INFLATION (PERCENT), 1989 – 2008



Source: IMF, World Economic Outlook Database, October 2008

the choice of the inflation targeting regime was in many instances intended to address an apparent lack of credibility and integrity and, therefore, weaknesses in the past monetary policy frameworks. It has thus been argued that countries with lasting policy credibility (such as the USA) would maintain price stability even without recourse to inflation targeting. For other countries (mostly middle-income and developing economies), exchange rate targeting facilitated the importation of credible policies and low inflation.

4.4 The following paragraphs highlight the experience of selected inflation targeting countries and how their choice of policy framework helped to entrench credibility and improve inflation performance, in terms of level and variability. New Zealand is the pioneer of inflation targeting, while the United Kingdom (an industrialised country) adopted inflation targeting following a loss of public confidence in its monetary policy framework of exchange rate targeting. Chile was the first of the emerging market economies to adopt inflation targeting and Brazil managed to achieve a record fast convergence of inflation

TABLE 2.5: INFLATION TARGETING COUNTRIES: TARGETS AND INFLATION PERFORMANCE

	Inflation Targeting Adoption Date	Inflation Rate at Start (percent)	Current (2008) Inflation Target (percent)	Average Inflation (percent)			
Emerging Market Economies				**1980–89**	**1990–99**	**2000–07**	**2008**
Brazil	1999 Q2	3.3	4.5 (+/-2)	468.7	674.4	7.0	6.3
Chile	1999 Q3	2.9	2-4	20.9	10.9	3.5	8.5
Colombia	1999 Q3	9.3	5 (+/-0.5)	23.3	21.4	6.3	7.2
Czech Republic	1998 Q1	13.1	3 (+/-1)		14.3	2.7	5.7
Ghana	2007 Q2			45.5	27.0	18.9	17.8
Hungary	2001 Q2	10.5	3.5 (+/-1)	18.1	21.8	6.3	5.5
Indonesia	2005 Q3	7.8	5.5 (+/-1)	9.0	14.9	9.1	12.0
Israel	1997 Q2	8.5	1-3	126.0	10.6	1.6	5.1
Korea	2001 Q1	3.2	2.5-3.5	7.8	5.6	3.1	5.0
Mexico	2001 Q1	8.1	3(+/-1)	74.2	20.2	4.9	5.7
Peru	2002 Q1	1.5	2.5 (+/-1)	642.8	793.9	2.2	5.8
Philippines	2002 Q1	3.8	5-6	14.1	9.2	5.1	12.2
Poland	1998 Q4	9.9	2.5 (+/-1)	81.3	33.0	3.1	3.0
Romania	2005 Q3	8.8	7.5 (+/-1)		123.4	16.5	7.9
Slovak Republic	2005 Q1	3.2	3.5 (+/-1)		8.4	5.4	4.1
South Africa	2000 Q1	2.3	3-6	14.5	9.4	5.8	12.7
Thailand	2000 Q2	1.7	0-3.5		4.6	2.1	2.5
Industrialised Countries				**1980–89**	**1990–99**	**2000–07**	**2008**
Australia	1993 Q2	1.9	2-3	7.8	2.3	3.2	4.8
Canada	1991 Q1	6.2	1-3	6.3	2.1	2.3	2.9
Iceland	2001 Q1	3.9	2.5	38.0	3.4	4.8	14.9
New Zealand	1990 Q1	7.0	1-3	9.9	1.9	2.7	4.8
Sweden	1993 Q1	4.8	2(+/-1)	7.7	3.4	1.8	3.3
United Kingdom	1992 Q4	3.6	2	6.9	3.2	1.6	4.6

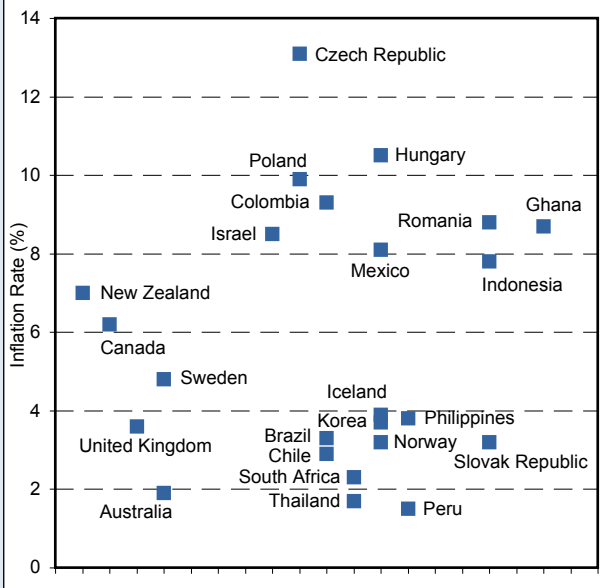
Source: Central bank websites; IMF

to international levels without inducing internal disequilibria. South Africa represents an example of an inflation targeting country in the Southern African region. Table 2.5 summarises the inflation performance of these countries relative to their targets. In contrast, the USA is an example of an industrialised country which has not adopted inflation targeting, but has achieved largely successful inflation performance derived from lasting policy credibility.

New Zealand

4.5 Inflation in New Zealand averaged 15 percent through the 1970s and 1980s, a level that was not only high in absolute terms, it was also high relative to most industrialised countries and, therefore, detrimental to both domestic macroeconomic stability and external competitiveness. In April 1988, the government (through the finance ministry) required the Reserve Bank of New Zealand to bring inflation down to a range of 0 – 2 percent per annum. The central bank engaged in a concerted disinflation effort and the inflation targeting monetary policy framework was formally adopted in 1990. As a result of the disinflation measures, inflation fell below 2 percent in 1991, but with an adverse impact on economic growth and employment. The economy subsequently recovered in a more

CHART 2.2: INFLATION TARGETERS: START DATES AND INITIAL INFLATION



Source: Data for the chart sourced from central bank websites and IMF.

conducive environment of price stability. In the six years to 1997, annual GDP growth averaged 3.5 percent and unemployment fell from 11 percent in 1992 to 6.7 percent in 1997, while inflation averaged 2 percent over the period. This success in attaining price stability has been sustained, as indicated by subsequent maintenance of inflation within the target and generally robust output growth (Table 2.6).

United Kingdom

4.6 In the late 1980s and early 1990s, the United Kingdom increasingly relied on exchange rate targeting, including through membership of the Exchange Rate Mechanism (ERM) of the then European Community (from 1990 to 1992). At the time of joining the ERM, UK's inflation was around 10 percent, but it subsequently fell rapidly due to a combination of economic recession and lower inflationary expectations resulting from the ERM membership. However, for the UK to remain in the ERM exchange rate band, it was necessary that the pound should have an interest rate premium over the German deutschemark. With interest rates in Germany pushed higher due to demand pressures arising from national re-unification, this policy proved unsustainable for the UK given that the economy was facing serious recession, and the markets did not have faith in the UK's commitment to the ERM. As a result, in September 1992, following heavy currency speculation, sterling was removed from the ERM, with the authorities making a clear choice to give preference to domestic objectives over the exchange rate anchor.

4.7 The pound sterling withdrawal from the ERM seriously eroded the authorities' credibility. In response to the urgent need to fill the resulting void with a credible monetary policy framework, the UK adopted the inflation target range of 1 – 4 percent as the sole monetary policy objective in October 1992. In addition, while the Chancellor of Exchequer retained responsibility for monetary policy decisions, the Bank of England (which had implementation responsibility) would publish quarterly inflation reports, including forecasts. This latter provision represented a change in the working relationship between the Treasury and the Bank of England as, by allowing the central bank to comment publicly on the effectiveness of monetary policy, the government was increasing transparency and accountability. The strategy was developed further with public announcement of the schedule for meetings between the Chancellor

TABLE 2.6: TARGETS AND INFLATION PERFORMANCE FOR SELECTED COUNTRIES

Country	Inflation Target	Average Inflation During the Targeting Period	Percentage of Time Inflation Target Met (Percent)
Brazil	4.5 (+/-2.0)	7.0	50
Chile	(2-4)	3.5	75
South Africa	(3-6)	5.6	71
New Zealand	(1-3)	2.1	88
United Kingdom	2	1.8	60

Source: Central bank websites; IMF.

and the Governor of the Bank of England, at which monetary policy would be discussed before the Chancellor made decisions on interest rates. Furthermore, the minutes of the meetings, including the full text of the Bank of England's advice to the government, were published, thus making it clear the extent to which the advice of the central bank was being followed. Nevertheless, the new framework fell short of being fully-fledged inflation targeting, as the central bank did not have instrument independence for policy implementation.

4.8 This system was maintained until 1997, when, after a general election, one of the new government's first actions was to give the Bank of England the autonomy to determine short-term interest rates. The new framework, which was backed by legislation in 1998, had the following features:

(a) price stability was to be the main objective of monetary policy, in pursuit of which the Bank of England had autonomy to determine the level of short-term interest rates. Only if it did not prejudice price stability could the Bank of England take into account other objectives;

(b) interest rates were to be set by a monetary policy committee (MPC) comprising both senior Bank of England staff and external members appointed by the government. The minutes of the MPC meetings and the voting record of the members were to be published;

(c) the operational definition of price stability was to be determined by the government on an annual basis. Initially this was set as 2.5 percent with a ±1 percent tolerance range, outside which the Governor must write an open letter to the chancellor explaining why the target had been missed and what corrective action was being taken. In 2003, the target was lowered to 2 percent following the switch to a different reference price index. [18]

4.9 Two factors were cited in the decision to give the Bank of England operational independence. One was the Bank's successful performance over time, as measured against an announced clear target; and the second was the anticipated further improvements arising from increased accountability of the central bank. Since adopting inflation targeting, UK inflation has remained relatively low and stable and this has clearly enhanced the credibility of monetary policy. The success of inflation targeting in the UK has not been unqualified since as the Governor has had to publicly explain a breach of the target, albeit only on two occasions, and this has underlined the transparency of the framework.

Chile

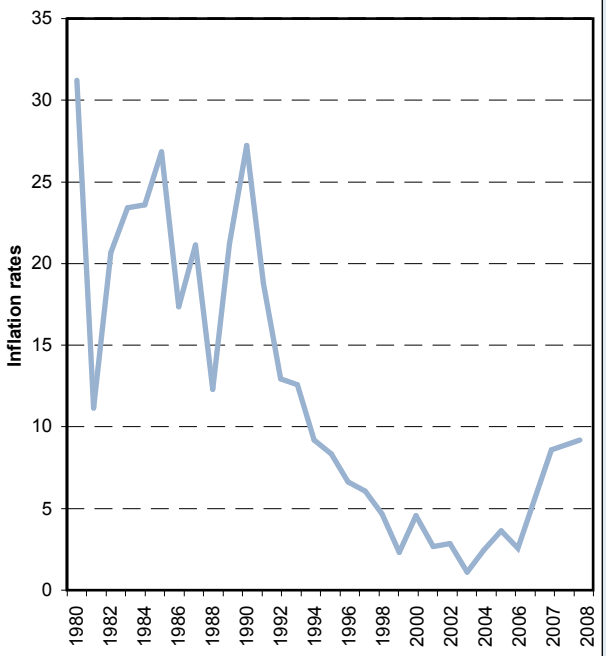
4.10 Chile experienced a high and unstable rate of inflation between 1980 and 1999. In the period 1979 – 1982, monetary policy was subordinated to a fixed exchange rate anchor; and later (1984 – 1999); this was amended to a crawling exchange rate band. In 1989, new legislation granted enhanced independence to the Bank of Chile, which, in turn, enabled the pursuit of the exchange rate objective concurrently with that of price stability, a framework described as partial inflation targeting. The inflation target was, however, dominant in the country's dual anchor system throughout the 1990s. The exchange rate target was primarily used to achieve a stable real effective exchange rate and was supported by intervention in the foreign exchange market, controls on capital inflows, as well as monetary policy, to the extent that it did not conflict with the inflation goal. Thus, whenever there was a conflict between the two objectives, the Central Bank of Chile would opt to maintain the inflation objective and make adjustments to the exchange rate bands. Effectively, from 1990, the emphasis on inflation as the primary objective

18 Specifically, in order to be more directly comparable with inflation measures used elsewhere in Europe, the Consumer Price Index (CPI) was adopted, in preference to the Retail Price Index (RPI). In both cases, the impact of interest rate changes on the price level was excluded from the target measure.

of monetary policy gradually increased and, subsequently, there was total abandonment of the exchange rate band in 1999, with the country adopting a fully-fledged inflation targeting framework. At the time, endemic inflation had been overcome and the policy was focused on maintaining inflation at a low level, and not on disinflation. Overall, the policy evolution from exchange rate targeting to inflation targeting was biased towards gradualism in moving from high to low inflation. In the circumstances, it took the authorities nine years to reach the long-run objective of an annual inflation rate of 3 percent (Chart 2.3).

4.11 The gradual approach also tends to minimise the costs associated with the trade-off between achieving low inflation and jeopardising output growth. In particular, the authorities recognised that, after a period of high and volatile inflation, it takes time for price stability to be entrenched by economic agents. With the achievement of the long-run inflation objective, an enhanced reputation of the central bank is critical in anchoring expectations and vitiating the need for indexation that was widespread in the past. As in other inflation targeting countries, credibility in Chile was maintained through transparency in the conduct of monetary policy, rather than solely by achieving the targeted inflation level. The key lessons from the Chilean experience are that the authorities recognised credibility as a key factor in the successful implementation of inflation targeting. As part of the measures to improve transparency and effectiveness of communication, the Central Bank of Chile has been publishing regular monetary policy reports and macroeconomic projections, as well as the schedule of the monetary policy committee meetings six months in advance since 2000. Press releases or communiqués of the monetary policy committee meetings are issued within 30 minutes of the end of the deliberations and the minutes of the MPC meetings are published within a period of three weeks following the meeting.

CHART 2.3: INFLATION RATE IN CHILE (1980-2008)



Source: Central Bank of Chile; IMF

Brazil

4.12 In 1994, annual inflation in Brazil was 994 percent; and to address the chronic hyperinflation, Brazil adopted a stabilisation programme known as the Real Plan[19] the same year, which contributed to the decline of annual inflation to 2 percent by 1998. However, the Real Plan did not provide a firm basis for long-term sound macroeconomic policies, but rather resulted in fiscal imbalances and exchange rate misalignments. By 1999, the fiscal imbalance and lack of policy credibility contributed to gross overvaluation of the domestic currency, leading to a massive exchange rate attack, which was also compounded by the Asian financial crisis. In the circumstances, the country was forced to abandon the fixed exchange rate regime and

19 The Real Plan was founded on three key elements: (1) a fiscal strategy centred on the Constitutional amendment creating a Social Emergency Fund; (2) a monetary reform process which would eventually lead to the adoption of a new unit of account; and (3) a move towards opening the economy, with aggressive trade liberalisation and an introduction of a new foreign exchange policy. The Brazilian real (BRL) was introduced July 1, 1994 as the official currency, replacing the cruzeiro, which had been the monetary unit since 1942.

immediately opted for an inflation targeting regime, which was implemented in July 1999. The inflation targeting framework aimed at containing the adverse pass-through of the exchange rate depreciation to inflation, as well as restraining inflation expectations through a restrictive monetary policy stance.

4.13 In a bid to improve transparency, the Central Bank of Brazil publishes regular monetary policy reports, the schedule of the monetary policy committee meetings and the minutes of the meetings with a one week lag. On the accountability front, if a target is breached, the governor of the central bank must present an open letter to the minister of finance outlining the reasons for the breach and measures adopted to reverse the deviation.

South Africa

4.14 South Africa changed gradually from monetary targeting, with seemingly multiple and opaque/unclear objectives in the mid-1990s.[20] With the advent of the democratic dispensation in 1994, the country's constitution gave greater independence to the South African Reserve Bank (SARB) in pursuing its primary objectives, albeit allowing for regular consultations between the Reserve Bank and the Minister of Finance. Towards the end of the 1990s, the SARB started to implement "informal inflation targeting". Under this framework, monetary aggregates were still regarded as vital elements in the inflation/price formation process, but the Reserve Bank closely monitored and considered the impact of developments with regard to other financial and real indicators when deciding on the appropriate level of short-term interest rates.[21] The implementation of informal inflation targeting achieved considerable success, with a significant decrease in inflation to just above 5 percent in 1999, compared to an average of 15 percent in the 1980s (Chart 2.4).

4.15 Although successful, it was observed that there was uncertainty associated with informal inflation targeting, particularly as the authorities may, on the basis of expert information available to them, act contrary to the public's expectations. South Africa, therefore, announced a formal inflation targeting framework in February 2000. It was considered that a formal framework would be more transparent, involve predictable policy responses and, in turn, anchor inflation expectations. In addition, the formal inflation targeting framework would, according to the authorities, improve policy coordination between monetary policy and other economic policies consistent with the price stability objective. Furthermore, inflation targeting was expected to foster a more disciplined approach to monetary policy formulation and ensure the central bank's accountability. Overall, the adoption of inflation targeting has enhanced implementation of monetary policy, with underlying price pressures and expectations appropriately anchored, despite the significant impact of exceptional influences, such as variability in food prices due to weather conditions, and large changes in administered prices, including fuel.

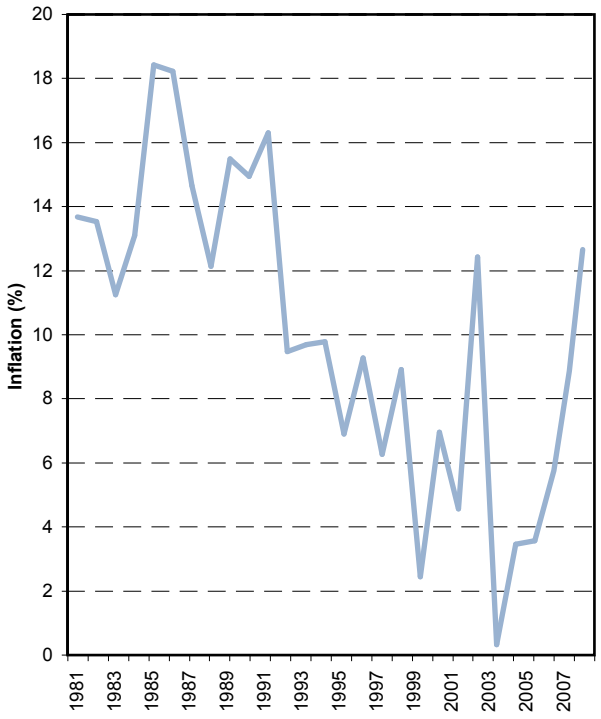
United States of America

4.16 The United States of America (USA) is an example of an industrialised country which has not adopted inflation targeting; and the Fed retains a dual mandate that places emphasis on both price stability and employment. It is argued that, similar to the impact of high and volatile inflation, variability in output and employment is also costly to the economy, while it is considered that the dual mandate

20 For example, the primary objectives of the South African Reserve Bank, as published in the mission statement in 1990, were to protect the internal and external value of the currency in the interest of balanced and sustainable economic growth in South Africa. This can be interpreted as having both price and exchange rate targets in mind, but without any explicit prioritisation of either of the objectives.

21 Aron, J. and Muellbauer, J. (September 2008), "Monetary Policy and Inflation Modeling in a More Open Economy in South Africa", in Hammod, G., Kanbur, R., and Prasad, E., (eds.) *New Monetary Policy Frameworks for Emerging Markets: Coping with the Challenge of Globalisation*, Bank of England/Edward Elgar (forthcoming in 2009).

CHART 2.4: SOUTH AFRICA'S INFLATION RATES (1981-2008)



Source: Reserve Bank of South Africa; IMF

framework affords more flexibility. The general success in controlling inflation has also engendered credibility of the framework; hence, public expectations are appropriately anchored.

Summary of Country Experiences

4.17 A common feature of inflation targeting regimes is the impact on expectations and anchoring of underlying inflation trends over the medium- to long-term. As articulated by Mishkin and Schmidt-Hebbel (2006), "inflation targeting seems to help countries achieve lower inflation in the long run, have smaller response to oil and exchange rate shocks, strengthen monetary policy independence, improve monetary policy efficiency, and obtain inflation closer to target levels … credibility of the inflation targeting regime improves once it has had success with disinflation and becomes a stationary regime."[22] While these authors also conclude that there is no evidence that inflation targeters outperform non-inflation targeters, particularly amongst the industrial countries, it appears that inflation targeting has enabled several countries to address institutional and credibility deficiencies, thus leading to better control of inflation and expectations.

5. BOTSWANA'S MONETARY POLICY FRAMEWORK

Policy Transition and Influences

5.1 Botswana moved towards gaining monetary policy independence in 1975 when the Bank of Botswana was established and the local currency, the Pula, was introduced in 1976.[23] The main policy objectives are:

(a) to promote and maintain internal and external monetary stability, an efficient payments mechanism and the liquidity, solvency and proper functioning of a soundly based monetary, credit and financial system in Botswana;

(b) to foster monetary, credit and financial conditions conducive to orderly, balanced and sustained economic development of Botswana; and

(c) to assist, in so far as it is not inconsistent with the objects as set out in (a) and (b), in the attainment of national economic goals.[24]

5.2 These basic objectives have not changed since the establishment of the Bank and have, over the years underpinned the formulation and implementation of monetary policy in Botswana. However, as in other countries, the monetary policy framework has evolved over time owing to financial and economic, as well as policy and institutional developments. The periodic key focus for monetary policy has been set out in successive National Development Plans (NDPs), where the interpretation of the monetary policy mandate reflected policy

22 Mishkin, F. and Schmidt-Hebbel, K., (2007), "Does Inflation Targeting Make a Difference", National Bureau of Economic Research, Working Paper Series, No. 12876.

23 Prior to this, Botswana was part of the Rand Monetary Area and the South African rand was legal tender.

24 Bank of Botswana Act (1996).

priorities and the development challenges. It is notable, for example, that the development challenges of industrialisation and facilitating access to financial services were key to policy formulation from the mid-1970s to the early 1980s. Although NDP 5 (1979/80 – 1984/85) stated that monetary policy would continue to be directed primarily at the promotion of domestic price stability and, secondarily, at a liberal exchange control regime, there was, in practice, a bias towards maintaining low interest rates to encourage borrowing for domestic investment. Consistent with the industrialisation objective, there were occasional increases in interest rates to encourage capital flows. In addition to the determination of interest rates, the other monetary policy instruments included the exchange rate (that was adjusted alternatively to mitigate imported inflation or to maintain domestic industry competitiveness) and exchange controls to protect the foreign exchange reserves.

5.3 The broad interpretation of the monetary policy mandate was maintained in NDP 6 (1985/86 – 1990/91), which clarified the complementarity of policies towards macroeconomic stability. There was, in this instance, a specific definition of stablisation as the "achievement of external balance, internal balance and efficient allocation of resources, together with reasonable price stability". The Plan also noted the role of monetary policy in regulating demand and in supporting fiscal policy, as well as contributing to the maintenance of a liberal exchange control regime. With specific focus on the external sector (external balance), variations in interest rates would affect short-term capital inflows or outflows, while limits to the growth of commercial bank credit would improve the balance of payments. Given the country's vulnerability to exogenous shocks affecting major exports, the accumulation of foreign exchange reserves in good periods would help sustain the development path and growth in the event of adverse global economic developments. As explained in the 2007 Bank of Botswana Annual Report, low interest rates to support financial flows to the economy could be maintained without engendering capital outflows only in an environment of binding exchange controls.

5.4 The broad objectives of monetary policy were unchanged in NDP 7 (1991/92 – 1996/97), while the exchange rate, exchange controls, the level and structure of interest rates and the liquidity position of commercial banks were specified as the key instruments of monetary policy. However, the thrust and conduct of monetary policy changed considerably during the 1990s, especially with the liberalisation of exchange controls and the financial sector.[25] Apart from streamlining the monetary policy objective to focus more clearly on price stability, it was necessary to construct a framework that would enable the application of indirect instruments of monetary policy in a liberalised environment, and operating through a more efficient transmission process. There was also a need to strengthen the capacity to mop up excess liquidity through open market operations, in particular to facilitate the desired increase in interest rates at the time. The use of Bank of Botswana Certificates (BoBCs) in open market operations, therefore, started in 1991 to strengthen the Bank's leverage over the market and influence the availability of loanable funds, as well as direct market interest rates towards desired levels of policy. Moreover, the goal of achieving positive real interest rates, articulated in 1996 (*Bank of Botswana Annual Report, 1996)* clarified the monetary policy objective and enhanced its predictability. In addition, with the introduction of BoBCs for liquidity management, as well as the focus of the exchange rate on the international competitiveness of local producers, the Bank Rate (interest rates) became the main monetary policy instrument. The definition of price stability as a monetary policy objective was spelt out in the 1997 *Bank of Botswana Annual Report,* which stated that, "monetary policy is directed mainly at the

25 This evolution of policy can be traced in detail through the *Annual Reports* and other publications of the Bank of Botswana over that period.

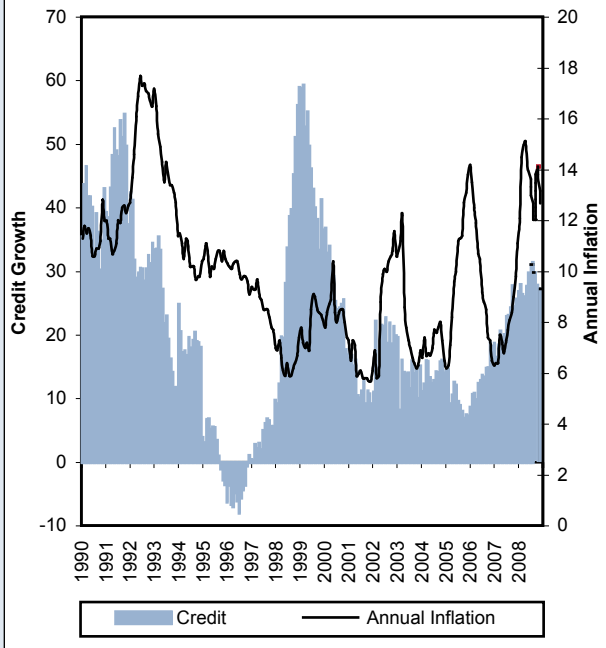
principal objective of the Bank of promoting and maintaining monetary stability" and that "monetary stability is primarily reflected in keeping the rate of inflation low and stable".

Botswana's Inflation Performance

5.5 Since the early 1990's, there has been relative success in controlling underlying inflation in Botswana. However, the overall inflation performance has been affected by exceptional and transitory factors, including adjustments to taxation, the exchange rate and administered prices. Among the reasons for these factors having a large impact on inflation is that with a narrow consumer price index (CPI) basket, individual items tend to have relatively large weights. Hence, sizeable price changes for these goods and/or services would have a large impact on overall inflation. In addition, in an environment of controlled or administered prices, including free or subsidised services and utilities over a long time, liberalisation or transition to market-related prices tends to involve large movements that have a substantial impact on the overall CPI. Revisions of the Botswana CPI basket have also been infrequent, such that its composition has not consistently been aligned to changing consumption patterns and the introduction of new goods and services. This is likely to have resulted in an overstatement of the inflation rates over the years. Overstatement of inflation due to improvement in quality of goods and services, also known as quality improvement bias, occurs when statistical agencies fail to adequately reflect improvements in product quality, thereby, attributing the part of a price increase that is due to improved quality to inflation instead.[26] In addition, consumers will tend to reduce consumption of goods which are subject to relatively higher rates of price increase. Consistent with research in this area, it can be argued that inflation in Botswana has also been overestimated.

5.6 After averaging 10.8 percent in the 1980s, annual inflation averaged 11.4 percent and 11.8 percent in 1990 and 1991, respectively. However, annual inflation increased to over 17 percent in mid-1992, a development attributed to, among others, a surge in domestic demand prompted by an increase in money incomes, the lagged effect of the 5 percent devaluation of the Pula towards the end of 1991, the widening of the sales tax in February 1992 to cover a broad range of goods, and the drought which led to a substantial increase in food prices (see Chart 2.5). From mid-1992, annual inflation maintained a downward trend to reach a single digit level of 9.7 percent in October 1994, the first time inflation had dropped below 10 percent in six years. Thereafter, except for the first three months of 1995, inflation fell continuously to reach 5.9 percent in July 1998, the lowest inflation rate in 13 years. The general decline in inflation over this period was associated with the monetary policy stance at the time. In particular, towards ensuring positive real rates of interest, the Bank Rate rose from 8.5 percent in 1990 to 14.25 percent in 1993. In addition to positive

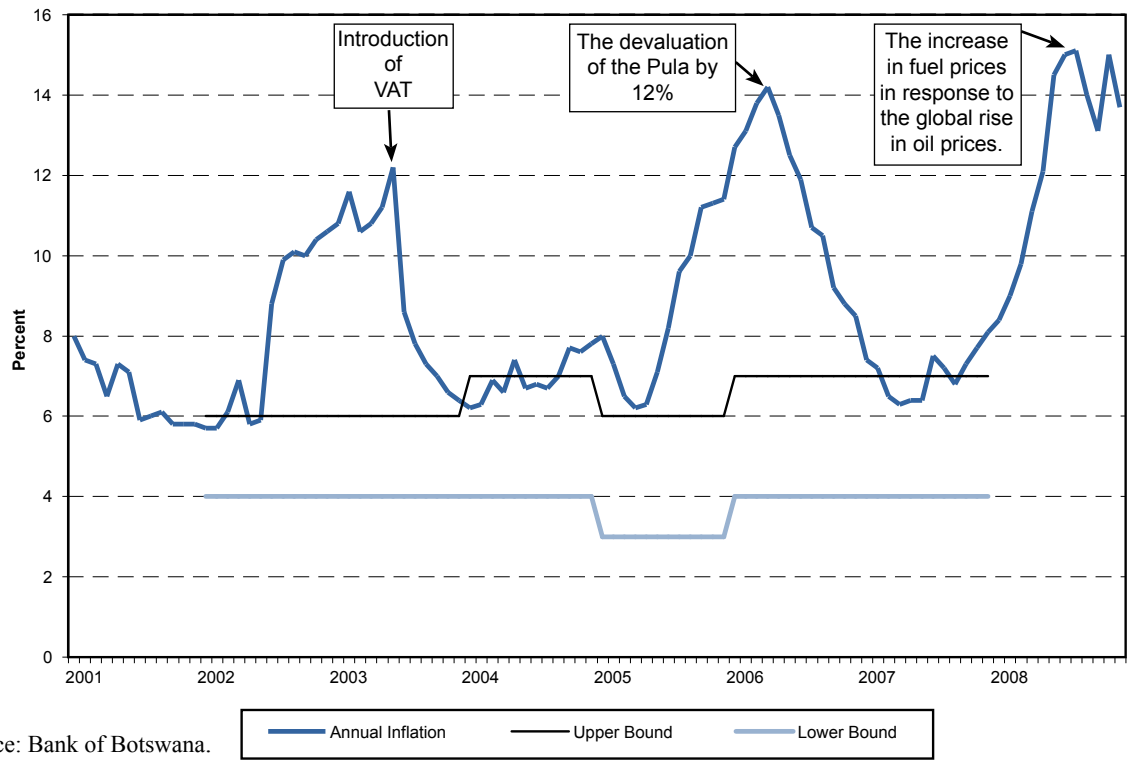
CHART 2.5: ANNUAL INFLATION AND CREDIT GROWTH, 1990 – 2008



Source: Bank of Botswana

26 Hanousek, J. and Filer, R. K., (2004), "Consumers' Opinion of Inflation Bias Due to Quality Improvements", William Davidson Working Papers Services, 2004 – 681, William Davidson Institute at the University of Michigan Stephen M. Ross Business School.

CHART 2.6: ANNUAL INFLATION VERSUS ANNUAL INFLATION OBJECTIVE

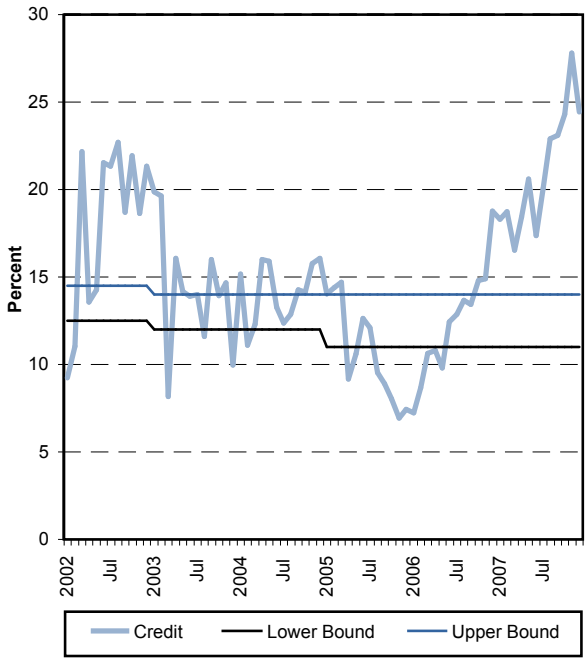


Source: Bank of Botswana.

real interest rates, the sustained tightening of monetary policy contributed to a considerable reduction in credit growth, hence lessening demand pressures. Chart 2.9 shows trends in real interest rates and Chart 2.5 shows movements in annual credit growth alongside inflation developments.

5.7 The enhanced focus on price stability by the Bank led to the publication of Monetary Policy Statements since 1998, which outlined the policy framework, as well as an assessment of the economic outlook, including prospective inflation developments and, in turn, the anticipated monetary policy stance in the ensuing period. From 1991 to 1996, there was a significant weight given to attaining positive real rates of interest comparable to those prevailing in international markets, rather than a specified level of inflation. From 1998, an inflation objective was derived internally in the Bank on the basis of forecast trading partner inflation. Attaining this level of inflation would ensure real effective exchange rate stability without the need to adjust the nominal effective exchange rate. To help achieve this level of inflation, an intermediate target of the annual rate of growth for commercial bank credit to the private sector was also determined as the sum of the long-run rate of growth in non-mining output, the inflation objective and a factor to account for financial deepening. The annual inflation objective was publicly announced from 2002, while a medium-term objective was added to the framework from 2006. Although the annual inflation objective was determined on the basis of forecast inflation for trading partner countries, invariably it was adjusted to reflect the likely inflation outcome, taking into account other prospective domestic price developments, albeit buttressed by the monetary policy stance. Meanwhile, the medium-term inflation objective reflected the Bank's view of price stability that is consistent with sustainable long-run growth of the economy. The medium-term (2 – 3 years) is considered a reasonable horizon over which monetary policy could impact on price developments without jeopardising long-term output growth (Annual Report, 2007). Chart 2.6 shows inflation performance vis-à-vis the annual objective, while Chart 2.7 shows annual growth rates in credit to the private sector

CHART 2.7: CREDIT GROWTH VERSUS TARGET GROWTH

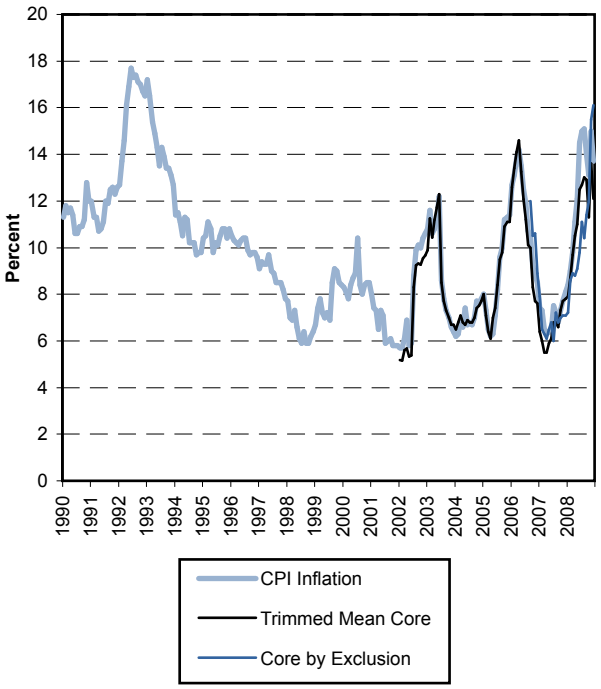


Source: Bank of Botswana.

compared to the targeted rate of increase.

5.8 Despite some success in containing inflationary pressures, exceptional developments, both locally and internationally, have challenged monetary policy formulation in Botswana and contributed to inflation that has been mostly higher than the objective. For example, most of the increase in inflation in 2002 occurred in the second half of the year due to the impact of Value Added Tax (VAT) that was introduced in July of that year; the drought conditions in the Southern African region that resulted in higher food prices; and the change in the telephone billing system in November that contributed to higher inflation at the end of the year.[27] As a result, in 2002 inflation rose from 5.7 percent in January to 10.6 percent in December. In 2004, the 7.5 percent devaluation of the Pula in February 2004 contributed about 2 percentage points to inflation, which ended the year at 7.8 percent. Inflation in the second half of 2005 was driven mainly by the 12 percent devaluation of the Pula in May and substantial increases in some administered prices, particularly fuel and telecommunication tariffs. Administered price changes and the May 2005 devaluation are estimated to have added 2.9 percentage points and 3 – 4 percentage points to inflation in 2005, respectively, while the estimated impact of the reintroduction of secondary school fees at the beginning of 2006 was 1.1 percentage points. Meanwhile, the inflation spike in 2008 mainly reflected the global increase in food and energy prices and, towards the end of the year, an increase in the tax levy on alcoholic beverages.

CHART 2.8: ANNUAL INFLATION



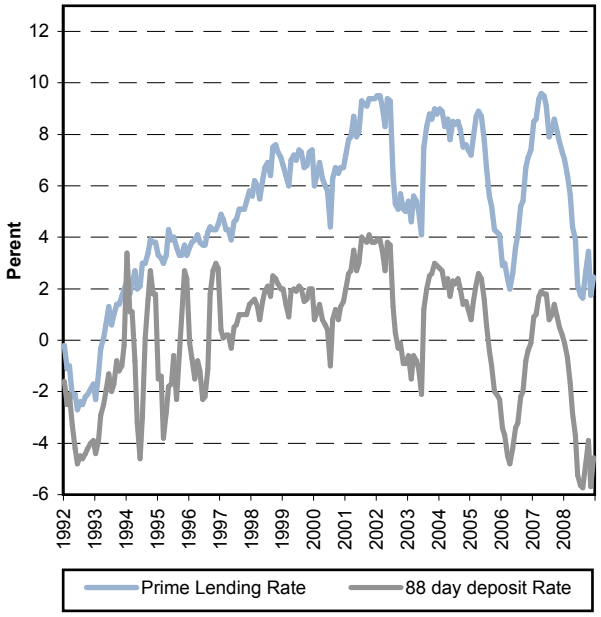
Source: Central Statistics Office and Bank of Botswana

The Current Bank of Botswana Monetary Policy Framework

5.9 The Bank's monetary policy framework underscores a continuing commitment to

27 There was a substantial increase, of 60.7 percent in the cost of the telephone call component of the CPI basket in November 2002 which, however, mainly reflected a change in the telephone billing system rather than an increase in the cost of telephone calls. Previously, telephone usage had been charged in units with a specified duration and the full cost of the unit was incurred even if only a fraction of the duration was used. The new billing system entailed charging on a per second basis, making shorter calls cheaper and longer calls more expensive, but was designed to be cost/revenue neutral in relation to the previous system. It was unlikely, therefore, to have resulted in an increase in telephone bills on average.

CHART 2.9: REAL INTEREST RATES



Source: Bank of Botswana

attaining price stability, defined as low, stable and predictable inflation, which at the same time is consistent with long-run sustainable growth of the economy. Price stability contributes towards sustainable economic growth and development to the extent that it promotes savings mobilisation and productive investment, as well as facilitating efficiency and better resource allocation. The framework also incorporates the use of the medium-term inflation forecast as a signal for the determination of the monetary policy stance, while the main instruments continue to be adjustment of the Bank Rate and the purchase and sale of BoBCs.

(a) Medium-Term Inflation Objective in 2008: The Bank's price stability objective was defined as inflation in the range of 3 – 6 percent to be achieved over a medium-term horizon of up to three years. From 2008, the Bank no longer specifies an annual objective. Instead, the time horizon for the inflation goal is the medium-term, which is considered a reasonable period over which monetary policy can affect inflation. It is recognised, therefore, that an adjustment in the policy rate (Bank Rate) is unlikely to have much impact on inflation in less than a year. Indeed, to a large extent, not only current inflation, but also inflation for the next twelve months, has already been determined by past economic events, including price shocks and policy decisions. The framework also defines the medium term as a three-year rolling period in recognition of the need for continuous review of the inflation outlook over the three-year period ahead, which would require corresponding proactive policy review. Therefore, the three-year rolling time horizon satisfies three considerations for the effectiveness of the framework. First, it anchors the setting of the inflation objective; second, it is a period over which inflation is forecast; and third, it is considered a reasonable period for policy action to take effect.

(b) Indicators for Policy Action – Forecast-Based Monetary Policy Formulation: As a signal for monetary policy action, the Bank focuses on the discrepancy between the medium-term inflation objective and the inflation forecast over the same period. This involves a response to the projected trend of inflation that is either significantly higher or lower than the price stability objective. Apart from the harmful effects of high inflation, the price stability objective takes account of the fact that significantly low levels of inflation could be indicative of subdued economic activity, which requires policy easing to stimulate growth. The inflation forecast incorporates the impact of several relevant economic factors and it also quantifies the extent to which each of these factors affects inflation and the time lag it takes for the impact to take effect. Among others, it is premised on the assessment that the main influences on inflation in Botswana include the gap between the demand for goods and services and the capacity of the economy to supply these goods and services; the level of interest rates; exchange rate developments; foreign inflation; changes in administered

prices; and inflation expectations (Box 2.2 describes the Bank's forecasting and policy analysis).

(c) Monetary Policy Instruments: The Bank's main policy instrument is the Bank Rate, which is adjusted as a signal for market interest rates to change in the same direction and magnitude desired by the Bank. For example, when the inflation forecast shows that the rate of increase in overall spending in the economy will far exceed the rate of expansion in the supply of goods and services and, therefore, raise inflation above the desired 3 – 6 percent range in the medium-term, the Bank increases the Bank Rate. This is followed by similar changes in deposit and lending interest rates by financial institutions. The higher lending rates would reduce the appetite for borrowing, while the higher deposit rates will enhance the incentive to save; the overall effect will be a slowdown in the rate of spending or demand. The reduced demand will also moderate price mark-ups by suppliers, if they are to compete in the market; the converse also holds. The Bank Rate and, therefore, market interest rates are also reduced or unchanged, when the medium-term inflation is forecast to be below or within the 3 – 6 percent range. The signal provided through adjustments to the policy rate is reinforced by the Bank's use of open market operations by absorbing excess (injecting) liquidity through the sale (purchase) of BoBCs. Hence, the availability of loanable funds is influenced such that market rates are maintained at a level that is consistent with the monetary policy stance.

5.10 Although the monetary policy framework in Botswana involves the determination of an inflation objective and is forecast-based, it does not equate to an inflation targeting policy regime. Significantly, in contrast to the prerequisites outlined in Section 3, there has not been any formal announcement of an inflation targeting regime and there is no numerical definition of price stability that has been legally mandated or agreed with the Government. The 3 – 6 percent inflation objective is an operational definition and represents the Bank's interpretation of the price stability objective implied in the Bank of Botswana Act. Furthermore, so far as monetary policy is concerned, the degree of transparency and accountability has evolved and improved over time, although it has not been legally mandated or agreed with the Government. There also continues to be a role for an exchange rate objective (target), which can be inconsistent or be in conflict with an inflation targeting regime.

5.11 Clearly, consideration of an inflation targeting monetary policy framework in Botswana would require a realignment of legal and institutional arrangements, as well as an adjustment of the macroeconomic policy mix and prioritisation of objectives. While the legal and institutional issues would formalise an inflation targeting regime, the determination of its appropriateness would need to reflect the development imperatives and growth prospects for the country. In particular, given the economic (and social) environment, it would be important to consider the extent to which fiscal and incomes policies would complement the price stability objective and the degree to which the flexibility of the exchange rate policy could be enhanced to accommodate a superior role for an inflation target or objective. These relevant economic and legal/institutional issues are highlighted below.

Monetary and Exchange Rate Policies

5.12 The efficacy or otherwise of monetary policy depends, to a very large extent, on the country's exchange rate regime, among others. At one extreme, a hard peg exchange rate regime renders monetary policy ineffective and, at the other end, a floating currency accords monetary policy maximum autonomy. With

BOX 2.2: THE STRUCTURE AND KEY CHARACTERISTICS OF THE BANK'S FORECASTING AND POLICY ANALYSIS

The Bank's inflation forecasting framework has two complementary elements, namely, the Near-Term Forecasting and the Core Model for Medium-Term Forecasting that, in addition to expert analysis and judgement, are used to support monetary policy formulation. These are based on assumptions and research on the policy and price transmission process. Figure A shows, in broad terms, the transmission process. The Near-Term Forecasting projects inflation for four quarters ahead and incorporates the influence of South Africa's inflation, the rand/Pula exchange rate, inflation persistence (represented by past inflation – a quarter earlier) and known/projected adjustments to administered prices (e.g., fuel prices and utility tariffs), government levies and consumption taxes. Prospective developments with respect to these factors, therefore, determine the forecast path for inflation over the next four quarters.

The Core Model for Medium-Term Forecasting is a structural representation that captures key relationships (the transmission process) in the Botswana economy. The model allows for consistent projections of up to 12 quarters ahead for key macroeconomic variables such as GDP, inflation, interest rates and exchange rates. In this formulation, the real variables are expressed in terms of the deviation from their trend values. An important feature of the model is the built-in policy response, in terms of: (a) adjustment to the policy interest rate (Bank Rate) to bring inflation to the target range, and (b) adjustment of the nominal effective exchange rate (through adjustment to the rate of crawl) in line with the inflation objective and underlying real trends.

The influences on the key variables are specified as follows:

- *(a) the output gap is determined by its past level, real monetary conditions index, South Africa's output gap and any aggregate demand shocks (e.g., increase in incomes, taxes, etc.);*
- *(b) inflation is explained by its past level, inflation expectations, import prices, output gap and shocks to aggregate supply;*
- *(c) real marginal cost influences are in the form of imported inflation and domestic demand pressures arising from the output gap;*
- *(d) exchange rate changes are consistent with the crawling band arrangement; and*
- *(e) adjustment of the policy rate (Bank Rate) to stabilise inflation around the objective and maintain trend output growth.*

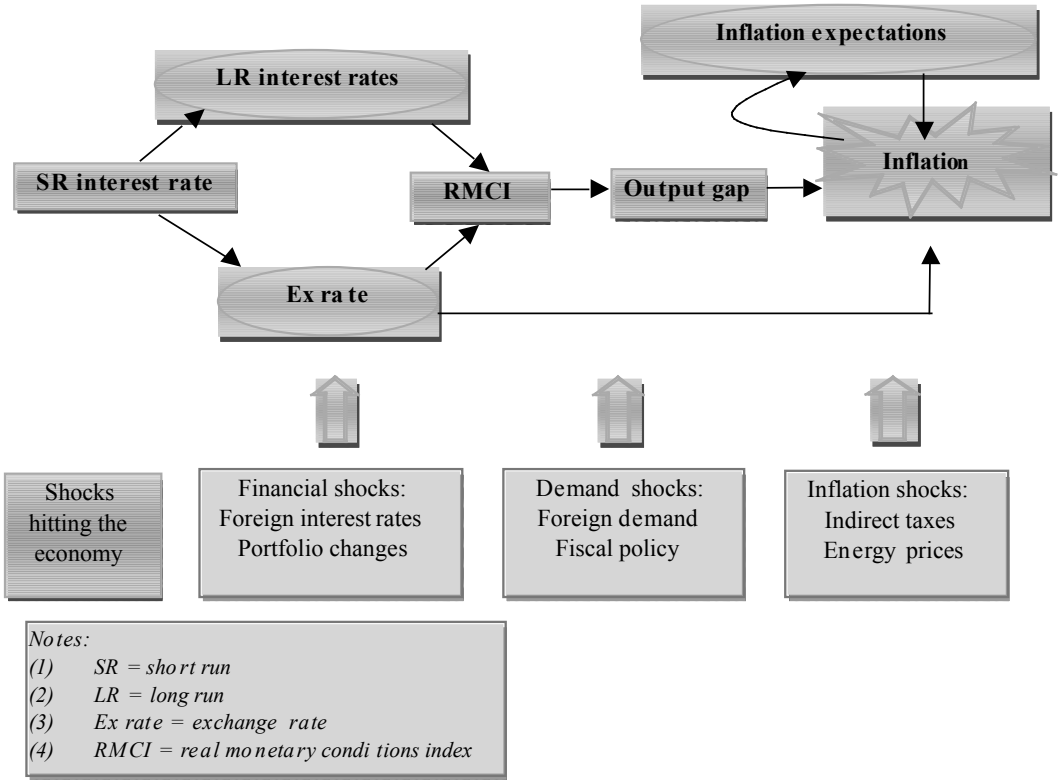
The output gap estimates the extent to which actual GDP is either above or below the long-run trend that is consistent with price stability. Excessively high output compared to trend is inflationary, while much lower output compared to trend is disinflationary. Real monetary conditions refer to the combination of the level of real interest rates and real exchange rates that define the extent to which monetary policy is restrictive or accommodative of output expansion in terms of financing and demand.

The process for generating price increases and inflation is based on three key assumptions:

- *(a) Monopolistic competition: a market structure that has many producers/sellers of similar, but slightly differentiated products (e.g., Nike versus Adidas; Mercedes versus BMW; Sony versus LG). Each producer/seller can set its price without affecting the market.*
- *(b) Imperfect substitution between factor inputs: faced with an increase in demand, suppliers would need to increase production and supply. However, while adjusting they cannot, in the short term, maintain the long term optimal relative proportions of the factors of production. For example, land and capital cannot be readily adjusted, but labour can be more quickly adjusted. Hence, workers are required to work more hours and/or there is an increase in the number of workers for the same amount of land and capital to meet an increase in demand. Therefore, initially labour productivity tends to decline and marginal costs of additional production increase. Hence, in addition to increasing supply, firms respond to an increase in demand by raising prices.*
- *(c) The magnitude of the price increase would, however, reflect both backward-looking (inflation persistence) and forward-looking inflation expectations.*

***Demand, output gap and real monetary conditions**: All things equal, an increase in the Bank Rate results in an increase in other market interest rates and adjustment of the exchange rate, to the extent it is flexible. These developments change the real monetary conditions and, consequently, the desire for borrowing, which affects aggregate demand. The response of firms to the lower demand determines the margin of the output gap and the rate of increase of prices.*

FIGURE 2.1: BOTSWANA'S MONETARY POLICY TRANSMISSION MECHANISM



Foreign price increases: *Other things remaining the same, local vendors would tend to pass on to consumers price increases of foreign-sourced goods and services.*

Exchange rate developments: *A change in the exchange rate will affect the import price of foreign sourced goods and services. The exchange rate, on the other hand, can be affected by capital flows (cross-border financial transactions) that respond to the variation in interest rate differentials. This channel is, however, weak in Botswana given that the exchange rate is not fully flexible and, therefore, does not respond to changes in interest rates. Nevertheless, a change in the Pula exchange rate from any source will be transmitted through this channel.*

Other price shocks: *For Botswana, these would include an increase in administered prices (mostly the cost of utilities and government services and others, such as fuel prices and transport fares). To the extent that these are artificially held below market levels for a long time, subsequent adjustments tend to be much larger than the general price trends and the inflation objective.*

Expectations: *Among other considerations, suppliers of goods and services and workers base their decisions on price increases and wage adjustments on what they expect inflation to be. Expectations can be both backward and forward looking. Those with backward looking expectations see inflation persisting at past levels and will be slow to respond to changes in policy actions that affect inflation. On the other hand, setting the inflation objective and entrenching the credibility of the policy framework can have a significant influence in encouraging forward looking expectations, which take account of the current and prospective conditions in determining expectations of future inflation.*

While there are significant foreign influences and other occasional shocks to domestic inflation (as shown in the bottom of Figure A), the monetary policy framework is premised on an understanding that the rate of domestic price increases reflects, in the main, local demand conditions and the policy environment. Monetary policy, therefore, has an impact on expectations and other second-round effects. First, the extent to which local vendors pass on foreign price increases to consumers will depend on local conditions with respect to competitiveness and demand for their goods and services. In turn, demand is influenced by the monetary policy stance and its effect on real monetary conditions. Second, a well articulated and credible policy influences expectations as a source of inflation; thus, generally, price increases and demand for wage adjustments would be related to the monetary policy stance and the extent to which the public believes the inflation objective to be achievable on a sustained basis. Third, a widely accepted price stability objective can influence the rate of increase in administered prices to be consistent with the inflation objective. In the circumstances, there is scope for policy coordination and a measured approach to such cost increases.

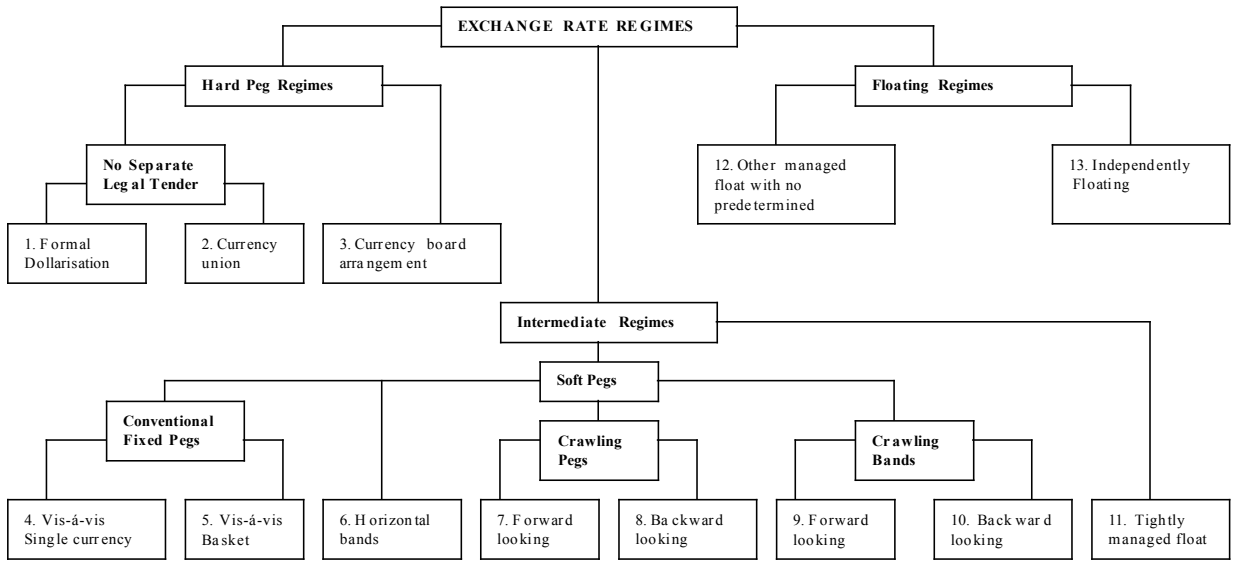
TABLE 2.7: EXCHANGE RATE REGIMES AND IMPLICATIONS FOR MONETARY POLICY AUTONOMY

Exchange Rate Regime	Definition	Implications for Monetary Policy
(a) Exchange Arrangements with no separate legal tender	Dollarisation (formal) – country adopts another country's currency as the sole legal tender or the country is a member of a currency or monetary union.	No independent monetary policy.
(b) Currency Board	Commitment to exchange domestic currency for a specified foreign currency at a fixed exchange rate.	Little scope for discretionary monetary policy.
(c) Conventional fixed pegs (vis-á-vis a single currency or a basket)	A country's currency is fixed to another country's (usually a major trading partner) or a basket of currencies (usually major trading partners). The basket weights reflect trade patterns.	Traditional central banking functions (monetary control and lender-of-last-resort) still possible, but limited flexibility of monetary policy though better than in (a) and (b).
(d) Peg exchange rates within horizontal bands	A country allows its currency to fluctuate around a fixed rate within certain margins.	Degree of monetary policy discretion depends on the band width (margins around the central parity).
(e) Crawling pegs (forward or backward looking)	The currency is adjusted periodically in small amounts at a fixed rate or in response to changes in selective quantitative indicators.	Monetary policy is constrained just as in the case of a fixed peg system.
(f) Crawling bands (forward or backward looking)	A country allows its currency to fluctuate around a fixed rate within certain margins, with periodic adjustment of the central rate, usually in response to some economic fundamentals such as inflation differentials. The exchange rate flexibility within the bands depends on the band width.	The degree of monetary policy independence depends on the band width.
(g) Other managed float with no predetermined exchange rate path	There is no specified exchange rate path or target. Management of the exchange rate is on the basis of various indicators such as balance of payments position, international reserves, etc.	Guarantees monetary policy independence.
(h) Independently floating	The exchange rate is determined by the market – interventions only aimed at moderating exchange rate fluctuations and not stabilising its level.	Guarantees maximum monetary policy autonomy

Source: IMF

a hard peg that is tantamount to exchange rate targeting, such as formal dollarisation or currency boards, a country cannot conduct an independent monetary policy; the central bank's control over domestic monetary policy is surrendered to the anchor country. Alternatively, intermediate exchange rate regimes facilitate monetary policy autonomy to varying degrees and provide countries with a choice of exchange rate fixity and monetary policy autonomy that might reflect the peculiar circumstances of the particular economy. For instance, soft pegs (e.g., crawling bands or pegs) provide more monetary policy autonomy than hard pegs; bands provide more monetary policy autonomy than pegs, while floating exchange rates provide even more monetary policy autonomy than bands. Overall, monetary policy autonomy (flexibility and effectiveness) improves with transition from fixed to flexible exchange rate regimes (Table 2.6 and Figure 2.1). This clearly shows that choice of an exchange rate regime plays an important role in determining the success of a central bank in conducting monetary policy. Furthermore, the level of autonomy the central bank has or that is desired depends on how strongly domestic financial markets are linked to international markets and the extent to which the exchange rate responds to capital flows.

FIGURE 2.2: EXCHANGE RATE REGIMES



5.13 The foregoing underscores the importance of carefully considering individual country circumstances and, in turn, the need to choose a monetary policy strategy and an exchange rate arrangement that are compatible and the importance of policy co-ordination. For countries like Botswana, there is a challenge in seeking to pursue an independent and active monetary policy in an environment where there are fundamental economic imperatives for restraining flexibility of the exchange rate. Specifically, economic literature makes reference to the so-called "impossible trinity" or "trilemma", which relates to the challenge of sustaining an active monetary policy, targeting inflation, in the context of free capital flows and a fixed exchange rate regime, (targeting the exchange rate).

Fixed Exchange Rate, Monetary Policy and Capital Flows

5.14 Ordinarily, active monetary policy involves the freedom to independently adjust interest rates in pursuit of the price stability objective. In turn, in the absence of exchange controls and where the currency is allowed to float freely, the adjustment of interest rates leads to changes in capital flows and the exchange rate. An increase in interest rates will induce more inward capital flows attracted by higher returns; consequently, the higher demand for the domestic currency will result in its appreciation (the reverse holds with respect to reduction in interest rates). Inflation will fall due to the combination of lower demand (resulting from higher interest rates) and lower import prices.

5.15 However, where the exchange rate is fixed, the inflow of capital does not lead to exchange rate appreciation; the exchange rate does not adjust to dampen inflationary pressures (i.e., the exchange rate channel is not active), while the inward flow of capital results in monetary expansion and inflation. Moreover, there is a policy option in a fixed exchange rate environment for a discretionary devaluation to sustain domestic industry competitiveness. Such action would induce inflationary pressures due to higher import prices, expressed in domestic currency, which conflicts with the pursuit of price stability through adjustment of interest rates. An increase in interest rates to mitigate inflationary pressures will, on the other hand, attract capital, resulting in inflationary monetary expansion.

5.16 In the light of the relationships and transmission processes described above,

policy and strategy choices relating to monetary and exchange rate arrangements need to be coordinated with a clear view of their likely effectiveness and balance in terms of objectives and the ranking of priorities. Due to their peculiar circumstances, where the low level of development is usually also manifested in a skewed economic structure, with the dominance of one or few sectors, it is common for small developing countries to maintain fixed exchange rates, either to a single currency or a basket of currencies. This arrangement helps mitigate the danger of domestic currency appreciation resulting from unusually high export earnings from one dominant sector eroding the competitiveness of other sectors. In addition to forestalling a possible macroeconomic imbalance, fixing the currency to those of larger trading partner countries also enables the smaller country to import and benefit from the credible policies of the larger countries. For example, several oil exporting Arab countries have pegged their currencies to the US dollar, with some countries including other currencies in a basket arrangement. For largely similar reasons and, most importantly, for the purposes of exchange rate stability, the Pula is pegged to a basket of currencies consisting of the rand and the SDR (the IMF's unit of account comprising the US dollar, euro, British pound and Japanese yen).

5.17 With a fixed exchange rate arrangement, a country is restricted in pursuing an independent monetary policy (implementing a change in interest rates), as the exchange rate does not adjust. While domestic price stabilisation can be achieved through discretionary exchange rate revaluation, this might be at the expense of competitiveness. Therefore, beyond a fixed exchange rate, several countries maintain intermediate arrangements, short of being fully flexible, such as the crawling band and peg. These exchange rate regimes allow some degree of fixity to maintain links with a strong economy with a credible policy framework, but with sufficient scope for the country to make adjustments to enable implementation of a more active monetary policy.

Botswana's Experience: Coordination of Monetary and Exchange Rate Policies and Constraints to Capital Flows

5.18 Notionally, the policy framework in Botswana might be considered a semblance of the impossible trinity. First, in the absence of exchange controls, there is free capital mobility in Botswana. Second, Botswana has a fixed basket exchange rate regime, albeit with a pre-determined crawling arrangement for the nominal effective exchange rate (NEER) and a small band around the central parity. Third, the Bank actively uses monetary policy in pursuit of price stability. However, in practice there is a degree of flexibility and scope for coordination to sustain a prioritisation of instruments and objectives. To that extent, several key issues are worth noting.

5.19 There is a constraint on capital mobility in Botswana since the domestic financial and capital markets are less developed, with limited instruments and a weak link with international markets. There is, therefore, less responsiveness of capital flows to interest rate changes and, in turn, potentially less pressure on the exchange rate and influence on monetary conditions. Moreover, there is also an element of flexibility in the exchange rate with the crawl mechanism and the +/- 0.5 percent margin around the central parity, which enhances autonomy of monetary policy.

5.20 The existing institutional arrangements and mechanisms for policy coordination are also key to alleviating the constraints of the impossible trinity and ensuring that important macroeconomic objectives are met. The objective of the exchange rate policy is to sustain domestic industry competitiveness, at the minimum by ensuring a stable real effective exchange rate (REER). The REER stability can be achieved through:

(a) achieving inflation that is equal to that of the trading partner countries;

(b adjusting the exchange rate by a rate equal to the inflation differential between

Botswana and her trading partner countries;

(c) a combination of partial achievement and insufficient rate of crawl, with respect to (a) and b).

5.21 The existing arrangements are such that, in the context of the crawling band exchange rate mechanism, the annual rate of crawl is determined on the basis of the differential between Botswana's inflation objective and forecast inflation for trading partner countries.[28] Thereafter, the Bank pursues an active monetary policy to achieve the price stability objective, which contributes towards attainment of a stable REER. Importantly, unlike in the past (i.e., before the introduction of the crawling band in May 2005), there is no scope for discretionary exchange rate adjustment that can conflict with the price stability objective.

5.22 Going forward, it is possible that financial markets in Botswana would deepen and become more integrated with international financial markets, with the potential to put more pressure on the exchange rate, as capital flows respond to interest rate adjustments. It is, therefore, acknowledged that in future there might be a need to adopt one of the policy choices of:

(a) inflation targeting where the focus is on monetary policy to attain low sustainable inflation as a contribution to macroeconomic stability and domestic industry competitiveness; or

(b) exchange rate targeting, where the Pula is fixed to an anchor currency or currencies that enable the importation of good policies that deliver low inflation in the domestic economy.

5.23 Monetary policy independence is, nevertheless, considered superior in an environment of overall good governance and macroeconomic stability. In the circumstances, policy adjustments have a direct relationship to domestic economic developments. For Botswana, it is envisaged that the transition from fixed to a crawling band arrangement will enable a gradual increase in flexibility of the exchange rate as the economy develops and diversifies.

Legal and Institutional Issues

5.24 Monetary independence and, in particular, an inflation targeting monetary policy framework requires a clear commitment by the Government and unambiguous delegated authority to the central bank (sometimes legislated), as well as the necessary infrastructure and communication strategies to sustain credibility and effectiveness in influencing expectations. The discussion below abstracts from the conceptual considerations highlighted in Section 3 and examines the status in Botswana with respect to the identified prerequisites and institutional arrangements for an inflation targeting monetary policy framework.

(a) Government Mandate

5.25 An important feature of an inflation targeting monetary policy framework would include an agreement on the definition of price stability between the Government and the Bank. Ultimately, the Bank is an agent of the Government that is delegated responsibility for, among others, formulating and implementing monetary policy to achieve price stability. In its current form, the Bank of Botswana Act has a broader reference to "monetary stability" alongside ensuring soundness of the financial and payments systems that is intended to provide conducive conditions for sustainable economic growth. So far the Bank has, over time, defined price stability and its role in supporting balanced growth as discussed earlier in this section. In the context of an inflation targeting regime, there is a general distinction between three facets of the price stability mandate, namely, goal independence, operational independence

28 Consistent with the Bank of Botswana Act, the ultimate annual rate of crawl is approved by His Excellency the President, following advice from the Minister of Finance and Development Planning and after the latter has consulted with the Governor of the Bank of Botswana.

and instrument independence. With goal independence, the Bank would be given a mandate to decide on the desirable inflation target and work independently to achieve the target. In the case of both operational and instrument independence, the Government would determine (or agree with the Bank) the inflation target and mandate the Bank to independently conduct operations and choose the instruments it would use to achieve the inflation target. In any event, the crucial requirement is for the Government to take ownership of the price stability objective as defined and that the mandate to the Bank should be formalised by legislation or directive. In the circumstances, other objectives, such as those relating to the exchange rate, would be subordinated to the price stability objective and fiscal operations would be aligned to the inflation target.

(b) Target Measure and Policy Horizon

5.26 The choice of the definition of inflation to target is also important in moving to an inflation targeting regime. The three alternatives published in Botswana are the headline inflation, inflation excluding administered prices and the 16 percent trimmed mean.[29] As indicated in Section 3 above, in choosing a target measure there can be a trade-off between controllability and credibility. Headline inflation engenders credibility as it is the most widely known, easily understood and the focus of expectations, while it is also viewed as being less susceptible to manipulation by the monetary policy authorities. The downside is that, in most instances, it contains elements and effects that cannot be influenced by central bank action. Hence, there is generally a preference by the monetary authorities for a narrower definition of inflation. For Botswana, in addition to formal adoption of any of the three[30] as the target measure, there is scope to develop other alternative measures of inflation that would be more relevant for monetary policy purposes.

5.27 In addition to the choice of the target measure of inflation, a formal determination of the use of a range (and width), as opposed to a point target, has to be made. It would appear that a range continues to be appropriate for Botswana, given more variable inflation and the relatively large impact of movements in single CPI items. Another element that requires formal agreement or mandate by the Government relates to the policy horizon, which is the period over which the Bank would be required, in the event of a deviation, to bring inflation back to within the target range. Assessment of the policy transmission process suggests that the medium-term horizon of 2 – 3 years represents a reasonable estimation of the period over which monetary policy in Botswana can affect price developments.

(c) Dissemination of the Model, Forecasts, MPC Schedule and Minutes

5.28 The Bank has a formal framework for economic and policy analysis, as well as forecasting of inflation, that informs the monetary policy stance. The Bank also communicates monetary policy issues and decisions through the annual Monetary Policy Statements and the mid-term review of the statement, as well press releases following the Monetary Policy Committee meetings. In an inflation targeting framework, dissemination and communication of this

29 Headline inflation is the broad measure derived from the overall consumer price index. Inflation excluding administered prices removes items for which price changes are not necessarily in response to prevailing market forces, and the volatility inherent in prices that are only adjusted periodically. Administered price items constitute 10.9 percent of the CPI basket. The 16 percent trimmed mean method excludes items that record price changes that are extreme compared to the median. Each month, 8 percent (by weight) of such items are excluded from both ends of an ordered series of percentage price changes of items in the CPI basket.

30 It is, however, less common for countries to use the more complex, stochastic measures such as the trimmed mean, which involve possible changes in excluded items with every calculation. More generally, in policy deliberations, alternative measures of inflation are useful complementary sources of information on the influences on price developments. Therefore, irrespective of the formal measure, most countries calculate a range of inflation measures, which are used extensively by central banks in policy deliberations.

kind of information will need to be enhanced by more detailed publication of the features of the Bank's models and forecasts in order to reinforce integrity and underpin the formation of expectations with respect to inflation and the monetary policy stance. An inflation targeting monetary policy framework will also entail publication of the schedule of the MPC meetings to help prepare the markets for these key decision dates, as well for the market to anticipate the factors that would be taken into account and the likely decision. Moreover, a decision will need to be made as to whether to emulate some advanced country central banks that publish the minutes of the MPC, the content of the minutes and the timing of publication.

(d) Members of the Monetary Policy Committee and Input

5.29 The Government might, as in other regimes, decide (with enabling amendment of the legislation) to appoint non-staff members of the Bank to be members of the Monetary Policy Committee on the basis of their expertise and with a view to widening the range of ideas and perspectives. It is considered that bringing in requisitely qualified and experienced outsiders has the potential to enhance transparency and integrity of the framework. It should, nevertheless, be understood that such appointments are not intended as stakeholder representation that advocates for, or protects, the interests of any specific group.

Summary View on Institutional and Legal Issues

5.30 While they may be consideration of the issues highlighted above in any future legal and institutional reform, particularly if an inflation targeting regime is adopted, the absence of initiatives in this direction do not necessarily undermine the current monetary policy framework. Indeed, the fact that a number of these prerequisites are linked, both to each other and to operation of a full-fledged inflation targeting monetary policy framework, makes it difficult to selectively implement these types of reforms within the current monetary policy framework. In particular, there can be uncertainty and risk to credibility where operational and institutional changes are not backed by a specific legal mandate or where market arrangements, performance and policy analysis lags behind. In recognition of this, the Bank has tended to prefer a gradual approach to reform of the policy framework that reflect both the pace of legal reform, developments in policy coordination, market advances and improvements in internal capacity.

6. CONCLUSION

6.1 There is generally a role for monetary policy in price stabilisation to support broad macroeconomic stability, economic activity and increases in living standards. However, as economies evolve and market innovations are undertaken, the frameworks employed to regulate the rate of increase in prices also need to change in order to remain effective. In addition, monetary policy frameworks, at any particular point in time, are not necessarily common across countries, but are specific to country conditions and policy preferences. However, there may be periodic trends and commonalities for categories of countries. For example, the use of monetary targeting was widespread in the 1970s and 1980s, when it was assumed that there was a constant definition of money that had a predictable and stable relationship with the rate of price increases. However, the efficacy and credibility of this framework was increasingly challenged by the impact of financial and payments innovations that destablised both the definition of money and the predictability of the impact of changes in money on prices.

6.2 Some middle-income and developing countries choose to secure policy credibility and stable inflation by fixing their exchange rate to that of a larger trading partner or widely used reserve currency (e.g., the US dollar). In turn, they forego monetary policy independence, perhaps in recognition of their own weaker credibility. A broader arrangement also involves several

countries constituting a currency board or monetary union and choosing to use one common currency and monetary policy. In a quest to re-establish credibility of their monetary policy, several countries adopted the inflation targeting monetary policy framework from the 1990s. It would appear that, for the respective countries, this approach, with a commitment to a defined price stability target, enabled concomitant structural, policy and institutional changes that contributed, generally, to success in regulating inflation. For example, the commitment by government to a single objective for monetary policy, responsibility for which was delegated to the central bank, facilitated complementarity between fiscal, exchange rate and monetary policies. The accountability and transparency entailed in this framework helped engender credibility and, therefore, anchor inflation expectations appropriately, thus contributing to the focus on productivity improvements, rather than inflationary wage and price increases, as the source for increases in profits and incomes.

6.3 The theme topic discussion also highlights the generalised lower inflation globally in the (late) 1990s and 2000s (except for the latter part of 2007 and in 2008 when substantial increases in oil and food prices led to a widespread rise in prices globally). Generally lower inflation over this period is attributable to the combination of improved credibility of monetary policy, changes in production and distribution processes (in part due to developments with respect to ICT and trade liberalisation) and associated productivity improvements. The impact of food and oil price increases and the current financial turmoil appear to have significantly challenged the scope and efficiency of monetary policy, in particular inflation targeting, in controlling inflation without destabilising economies and inducing (reinforcing) an erosion of welfare. However, there seems to be a general consensus that, while stability of financial markets can be occasionally challenged, they remain an important part of macroeconomic management and sources of welfare improvements; hence, the concerted efforts by the authorities to prevent the collapse of significant entities and to return the market to stability. Moreover, with credibility that has been established over the last two decades or so, medium- to long-term inflation expectations remain well anchored, thus facilitating a stabilisation role for monetary policy to support output growth.

6.4 The monetary policy framework in Botswana is evolving towards an inflation targeting regime. Given economic considerations and other competing policy objectives, it is neither necessarily desirable nor optimal for Botswana to adopt inflation targeting just yet. The major economic and policy challenges pertain to the need for the authorities to maintain some control over the level of the Pula exchange rate in order to avoid overvaluation which could thwart national strategies to diversify the economy, create jobs and reduce poverty. As indicated above, an inflation targeting regime implies targeting a single objective of price stability. For monetary policy purposes, all other objectives are subordinated to the price stability objective. In particular, there is likely to be a conflict and market uncertainty where an inflation target co-exists with a target for the exchange rate or a managed exchange rate. In the circumstances, policy credibility and expectations regarding price stability are undermined. However, for Botswana, a flexible exchange rate arrangement is not necessarily appropriate given an undiversified economy involving skewed and lumpy foreign exchange receipts that might result in extreme volatility of the exchange rate. At the same time, the greater value of exports of one commodity (diamonds) might tend to result in the appreciation of the Pula exchange rate to a point where it would become uncompetitive for the tradeable goods sectors. Botswana has, therefore, chosen to maintain a policy mix that involves pursuit of an inflation objective by the Bank of Botswana and the crawling band exchange rate arrangement, focused on stabilisation of the real exchange rate.

6.5 There are, nevertheless, advantages to a single objective of an inflation targeting framework for Botswana, particularly as this would reduce uncertainty and the potential for policy conflict. This chapter has, therefore, highlighted areas of improvements that would, even without an explicit announcement of an inflation targeting regime (in recognition of the economic considerations) improve efficacy, integrity and predictability of monetary policy. In this, respect, there would be a need to amend relevant legislation (the Bank of Botswana Act) and change institutional arrangements. Among others, these include an explicit commitment by the Government to a definition of price stability and delegated authority to the Bank to act independently in pursuit of this objective. It would also be important to clarify, for monetary policy purposes, the subordination of other objectives. Policy formulation could also be broadened by allowing for non-employees of the Bank to be part of the Monetary Policy Committee, which would be wholly accountable for monetary policy decisions. To help improve transparency and inform market expectations, communication and dissemination could also be enhanced to include prior announcement of MPC meeting dates and more extensive publication of the Committee's deliberations, voting and decisions. The forecast-based inflation targeting framework provides for continuous research on the policy and price transmission process, which inevitably changes with economic, financial and technological developments. Policy analysis is, therefore, more likely to remain relevant. The publication of such research, relevant models and forecasts also helps in entrenching credibility, and providing opportunities for informed critiques of the monetary policy framework.