BANK OF BOTSWANA

2014 MONETARY POLICY STATEMENT

by

Linah K Mohohlo
Governor

February 28, 2014

I wish to welcome you to the launch of the *Monetary Policy Statement* for 2014, which is by now well-known to be the premier event for the Bank. The Statement informs stakeholders how one of the Bank's key functions is discharged, and that is the formulation and implementation of monetary policy. The Statement is issued each year because the Bank attaches importance to the need for transparency and accountability in the discharge of this key mandate. That is why your dedicated patronage on this occasion is sincerely valued and appreciated.

As has been regularly explained, the principal objective of monetary policy is to achieve sustainable, low and predictable level of inflation and, at the same time, ensuring that the economy is financially stable. This is due to the fact that sustainably low inflation and a conducive financial environment support economic growth by fostering savings and productive investment, while promoting the competitiveness of domestic producers and contributing towards a more equitable income distribution.

This is the seventeenth year since the Bank has issued the annual Monetary Policy Statement; and perhaps this year's Statement is of particular interest. It is the first time that the launch takes place in circumstances in which inflation has been comfortably within the Bank's medium-term objective range for a sustained period. This outcome has afforded the Bank the scope to ease monetary policy in the course of 2013. I will have more to say about this shortly.

While this is, without a doubt, a positive development, it does not suggest a time for complacency with respect to the Bank's approach to monetary policy. On the contrary, the early weeks of 2014 have reminded us of the considerable uncertainty that continues to surround prospects for the global economy, and the vulnerability of emerging markets to related risks is turning out to be particularly acute. Therefore, the vigilance of the Bank, through the work of the Monetary Policy Committee and supporting structures remains undiminished.

As I intimated earlier, one of the core functions of the Bank is conducting monetary policy. Indeed, the **framework** through which the Bank carries out this function is now widely-known; you can bear testimony to the fact that any adjustment to policy is communicated to the public immediately after each meeting of the Monetary Policy Committee. The policy framework is forecast-based, with a medium-term outlook that primarily guides the Bank’s response to anticipated movements in inflation, while taking account of prospects for economic growth.

Central to the forecast is an assessment of the prevailing gap between long-term trend output and actual output as a leading indicator of inflation. It is recognised that other factors also contribute to inflation. These other factors include foreign inflation, exchange rate movements, changes in domestic administered prices and taxes, as well as expectations of future price movements.

Therefore, it is essential that policy credibility is underpinned by rigorous analysis of economic and financial developments, and by an assessment of future trends and associated risks, with a focus on anticipated price changes and their implications for the medium-term inflation outlook. There is also a consideration of relevant indicators of financial stability in the domestic economy. All these considerations will form the basis for the formulation and implementation of monetary policy in 2014.

Distinguished Ladies and Gentlemen:

I now wish to highlight **inflation trends and other economic developments** of the past year. You may recall that global output growth slowed marginally in 2013, from 3.1 percent in

2012 to an estimated 3 percent, resulting in modest inflationary pressures, as capacity utilisation and high unemployment in major economies persisted. With respect to commodities, international oil prices were stable because of the emergence of new sources of supply and the easing of geopolitical tensions in some oil producing regions. The increase in food prices was also restrained due to ample grain production. Consequently, global inflation decreased from 4 percent in 2012 to 3.8 percent in 2013.

Average inflation for Botswana's trading partner countries declined from 4 percent in 2012 to 3.4 percent last year. The countries the currencies of which comprise the Special Drawing Rights (that is, the United States of America, Eurozone, Japan and the United Kingdom) also experienced a decline in inflation, from an average of 1.9 percent to 1.3 percent in the same period, mostly due to weak economic activity, lower food inflation and the moderation in international oil prices. Price movements in South Africa followed the same trend; they slowed down from 5.7 percent in 2012 to 5.4 percent in 2013, in this way, remaining within the medium-term target range of 3 – 6 percent.

In Botswana, inflation maintained a downward trend too, moving within the Bank's medium-term objective range by June 2013.

By the end of the year, inflation had declined to 4.1 percent, compared to 7.4 percent in December 2012.

In the event, price increases were subdued across a broad range of goods and services, including food. In fact, commodity groups representing about 90 percent of goods and services in the Consumer Price Index basket were within the objective range. Overall, inflation excluding administered prices decreased from 6.8 percent in December 2012 to 4.7 percent in December 2013, while the 16 percent trimmed mean measure of core inflation fell from 7.1 percent to 4 percent.

The sustained decline in inflation was due to a dissipation of the impact of the increase in administered prices effected in 2012. The moderate increase in prices was also indicative of benign domestic demand pressures. The impact of government spending on economic activity was small in the context of fiscal consolidation measures, with annual government expenditure growth limited to only 2 percent.

To some extent, demand was supported by continued growth in commercial bank credit, especially to households, which went up at a faster rate, from 21 percent in December 2012 to 24.2 percent by the end of 2013. It was observed that growth in household credit was led by mortgage lending, which grew by 43.3 percent. The continued rapid expansion in household credit also reflected, in part, some improvements in financial services provision and financial inclusion. Nevertheless, the level of household debt, which is dominated by personal loans, in an environment of slow growth in incomes, is a cause for concern. While current indicators, such as low default ratios, suggest that widespread default risks are not imminent, the related emerging debt repayment burden for households warrants close attention.

In contrast, there was a marked deceleration in the growth of business credit, from 26.8 percent in December 2012 to only 4.6 percent in December 2013. The slowdown in the growth of business credit is reflected in virtually all economic sectors, and is in line with the moderation of growth in economic activity. For instance, the annual growth in non-mining GDP slowed to 5.1 percent in the twelve months to September 2013, compared to 8 percent a year earlier.

Honoured Guests:

Implementation of monetary policy in the past year posed an interesting challenge. From a global perspective, there was sluggish demand, weak economic activity, lacklustre financial intermediation and benign inflationary pressures. All the same, there was positive sentiment flowing from faster output growth and decreasing unemployment rates in the United States of America and United Kingdom; the euro area too emerged from recession. Output expansion in emerging market economies remained robust and spurred global economic performance.

Monetary policy in major economies carried the burden of supporting economic recovery as fiscal austerity programmes remained in place. It was mostly accommodative and involved maintenance and, in some instances, reduction of the already low policy interest rates. Some of the major central banks used forward guidance to indicate thresholds for unemployment and growth; this was adopted with a view to guiding market interest rates in the medium term and to foster investment and demand. In contrast, the more imminent threat of rising inflation in emerging market economies resulted in some policy tightening.

Here at home, monetary policy was conducted principally through open market operations to absorb excess liquidity from the banking system and maintain market interest rates at required levels. The Monetary Policy Committee continued to assess the impact of economic and financial developments on inflation prospects. The effect of credit growth on the quality of banks' assets, the growing burden of household debt and the potential for asset price bubbles were also kept under review. The result was the reduction of the Bank Rate by a cumulative 2 percentage points to 7.5 percent during the year, against the background of, among others, below-trend GDP growth and a positive outlook for inflation in the medium term. Accordingly, commercial banks reduced their prime lending interest rates by the same magnitude to 9 percent, with corresponding movements in most other market interest rates.

As a related matter, and in a bid to reward depositors, commercial banks have been advised to publish and offer to customers their 91-day deposit products. These products pay an interest rate that is, at a minimum, 3.5 percentage points below the Bank Rate. Longer dated deposits are expected to attract commensurately higher interest rates.

In terms of the **outlook for inflation**, the global economy is projected to grow by 3.7 percent in 2014. This compares with the estimated growth of 3 percent for 2013. The recent upward revision to the forecast reflects improving sentiment for global economic prospects. There are some risks to the forecast, however, which relate to a potential reversal of capital flows that could follow the ongoing wind-down of asset purchases in the United States of America. This could undermine growth prospects for emerging market economies, which have been a major source of global economic growth.

Global inflation is projected to maintain the 2013 level of 3.8 percent. This is against the background of stable commodity prices, subdued output growth and persistence of spare capacity, as well as high unemployment rates in major economies. There may, however, be upward pressure on inflation in some emerging market economies, given robust economic activity and lower unemployment rates.

Monetary policy in major economies is expected to focus on maintaining an accommodative stance, providing liquidity and fostering resilience of the financial sector. In contrast, emerging economies are likely to have a bias towards policy tightening, in response to emerging global risks of capital outflows to industrialised economies, and the need to focus on structural weaknesses of their respective domestic economies.

The domestic economy is forecast to grow by 5.1 percent in 2014, compared to last year's GDP growth of 5.4 percent. Demand will be supported by the growth in government expenditure, for which budgetary allocations for the 2014/15 fiscal year have increased by 8.5 percent, with the bulk of the additional spending concentrated in the recurrent budget. Business confidence remains muted, but the recent successful transfer of diamond aggregation and sales functions from the De Beers London office to Botswana should serve to boost domestic economic activity.

On the exchange rate front, I wish to submit that the crawling band exchange rate policy has continued to serve the purpose for which it was established, which is to render domestic industries internationally competitive and contribute towards macroeconomic stability and economic diversification. You will, by now, know that the parameters of the exchange rate policy were recently made public by the Honourable Minister of Finance and Development Planning. Indeed for 2014, the Pula basket weights are 55 percent for the South African rand and 45 percent for the Special Drawing Rights. The Pula will crawl downward by 0.16 percent, given that the inflation objective range of 3 – 6 percent is marginally higher than the projected average inflation range of trading partner countries of 3 – 4 percent.

Overall, it is expected that pressure on inflation from domestic demand will be low in 2014, as will the impact of foreign price developments. Therefore, inflation is projected to remain within the medium-term objective range of 3 – 6 percent. This means there will be further scope for monetary policy to support economic activity through the current accommodative policy stance, while maintaining price stability. As usual, the Bank will respond appropriately to any sustained deviation of the inflation forecast from the objective range and to any emerging threat to financial stability, where the causal factors can be influenced by monetary policy action. Be that as it may, any upward adjustment in administered prices and government levies or any increase in international food and oil prices beyond current forecasts will present upside risks to the inflation outlook. Furthermore, any substantial civil service wage increase could also generate inflationary pressures through higher demand and inflation expectations.

Distinguished Ladies and Gentlemen:

I conclude by reiterating that the domestic economy is expected to be characterised by an environment of benign inflationary developments in 2014. The Bank's formulation and implementation of monetary policy will focus on entrenching expectations of low and sustainable inflation in the medium term, through timely responses to price developments, while ensuring that credit and other market developments are consistent with lasting financial stability.

I thank you for your attention.

Copies of the detailed Monetary Policy Statement are in the foyer of the Auditorium; please obtain a copy so you can read it at your leisure.