

BANK OF BOTSWANA

PRESS RELEASE

The Monetary Policy Implications of the Introduction of Value Added Tax (VAT)

The new Value Added Tax (VAT) comes into effect on July 1, 2002. The tax will replace the current 10 percent sales tax and apply to a wider range of goods and services. As a result, there is likely to be an increase, beginning in July and continuing for several months after, in the prices of those items that will attract VAT for the first time and in others that have not previously been covered by the sales tax up to the retail level.

It is difficult to determine beforehand the exact extent of the VAT-related increase in prices, but provisional estimates by the Bank suggest that the tax, when fully implemented, will result in a one-off rise in the Consumer Price Index (CPI) in the range of 4 percent to 6 percent. This will result in a similar rise in the annual headline rate of consumer inflation from July 2002 through to mid-2003. A range of factors will determine the speed and extent of the VAT-related increase in prices and inflation. However, important considerations in limiting the rise will be the strength of the competitive environment in the business and commercial sectors, and the reaction of consumers to any price increases that may occur.

The Bank, therefore, recognises that there will be a temporary increase in headline inflation due to the introduction of VAT. Since the impact of VAT on the inflation rate is temporary, there should be no need for a monetary policy response. The issue for monetary policy is to ensure that this one-off increase in the general level of prices and headline inflation is not allowed to become a progressive and sustained increase in the rate of inflation. In assessing inflationary developments, monetary policy will be guided by underlying trends, which will discount the one-off impact of VAT, rather than headline inflation. However, in order to achieve its inflation objective, monetary policy will be tightened if subsequent developments suggest that the introduction of VAT is causing an upward trend in inflation that is not warranted by the new tax. In this connection, the main risk is if wages, in both the public and private sectors, are adjusted upwards in response to the effects of the new tax on prices. However, prices could also rise over and above the VAT-related cost if the business and commercial sectors take unfair advantage of the expectations of a general increase in prices due to the introduction of VAT. Such developments would result in a second round of price increases that may lead to a more sustained rise in inflation, which would require a monetary policy response.

In the circumstances, the Bank will monitor inflation trends very closely following the introduction of VAT to ensure that its monetary policy stance of maintaining sustainable low and stable inflation is adhered to both in the short and medium term.

June 21, 2002