MONETARY POLICY STATEMENT 2013

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1. INTRODUCTION

1.1 The Bank of Botswana's annual Monetary Policy Statement (MPS) is intended to review the past year's economic developments, evaluate the main determinants of price changes and the extent to which inflation deviated from the Bank's medium-term inflation objective range of 3 – 6 percent. Furthermore, the MPS assesses prospective economic and financial developments that are likely to affect the outlook for inflation in the medium term and, consequently, the Bank's policy choices for 2013. In this respect, the Bank desires to promote policy credibility with a view to anchoring public expectations of a low, predictable and sustainable level of inflation.

1.2 Globally, economic performance deteriorated in 2012, largely due to developments in major economies, such as fiscal austerity, high rates of unemployment, bank deleveraging (which tends to weaken financial intermediation, thus limiting financial flows) and policy uncertainty. These factors had a negative impact on investment and demand. However, economic growth in emerging markets was robust, albeit relatively slow due to reduced international trade. In the circumstances, inflationary pressures were low in 2012, against the background of modest global economic activity and broadly stable commodity prices. This gave way to accommodative monetary policy which was aimed at supporting economic activity and growth.

1.3 As anticipated in the 2012 MPS, domestic inflation maintained a downward trend during the year; it fell from 9.2 percent in December 2011 to 7.4 percent in December 2012. However, the projected convergence to the 3 – 6 percent objective range was not realised due to the unanticipated increase in administered prices and government levies. Demand pressures on inflation were generally low, with household spending constrained by weak growth in wages, while stimulus from government expenditure was modest. However, strong credit expansion helped stabilise demand and drive economic activity. The result was an increase in money supply (3.8 percent in November 2012), and GDP growth of 7.7 percent in the twelve months to September 2012.

1.4 Given low domestic demand pressures and benign external price developments, the outlook for inflation in Botswana was positive, despite short-term price developments contributing to a higher level of inflation relative to the objective range of 3 – 6 percent. Hence, the policy rate (Bank Rate) was kept at 9.5 percent in 2012. As inflation in Botswana was higher than the anticipated average inflation of trading partner countries, the exchange rate policy was implemented to ensure a modest downward crawl of the nominal effective exchange rate (NEER) in order to help maintain international competitiveness of producers of tradeable goods. Movements in bilateral exchange rates were small, with the Pula appreciating by 0.4 percent against the South African rand and depreciating by 3.4 percent against the SDR[1] in the twelve months to December 2012.

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[1] *The SDR is a unit of account of the International Monetary Fund and is constituted by the United States dollar, British pound, euro and Japanese yen.*

1.5 Looking ahead, inflation is projected to remain above the medium-term objective range in the short term due to the residual effects of the increase in administered prices in 2012. It is projected to converge to the 3 – 6 percent medium-term objective range later in the year (2013), in view of low domestic demand and benign foreign inflationary pressures associated with below-trend domestic and global economic activity. Upside risks to the inflation outlook include any substantial increase in administered prices and government levies, as well as international food [2] and oil [3] prices beyond current projections. This could, however, be mitigated by the downside risks associated with the envisaged weak global economic performance.

2. MONETARY POLICY FRAMEWORK

2.1 The Bank's monetary policy objective is to achieve price stability, which is defined as a sustainable level of inflation that is within the medium-term objective range of 3 – 6 percent. Such a low and predictable level of inflation contributes towards the broader national objective of sustainable economic growth and development that is attained through savings mobilisation and productive investment, and which fosters international competitiveness of domestic producers.

2.2 In pursuit of the objective of price stability, the Bank uses interest rates and open market operations to affect demand conditions in the economy and, ultimately, the rate of increase in prices. Changes in interest rates and the availability of loanable funds influence choices with respect to credit demand and saving and, in turn, the determination of aggregate demand. Domestic demand conditions[4] and other factors, such as foreign inflation, exchange rate, changes in administered prices and taxes, contribute to the level of inflation. Public expectations with respect to the future level of inflation also influence price changes by firms and wage adjustments.

2.3 The monetary policy framework entails assessing prospective developments of various factors that can influence price movements, thereby allowing the Bank to generate an inclusive and broad-based forecast for inflation in the medium term that, in turn, informs the monetary policy response. In this way, the Bank determines the factors (including public expectations) that are likely to lead to a longer-lasting deviation of inflation from the objective range and those that have a transitory impact, as indicated by the duration of their disaggregated effect on the inflation forecast.

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[2] *The United Nations Food and Agriculture Organisation reported a steady rise in world food prices in the second half of 2012, with expected tightening of global supply in crops, such as grain, in the 2012/13 ploughing season, following unfavourable weather conditions in a number of major producing regions. However, compared to 2011, global food prices were generally lower and less volatile.*

[3] *The upside risk for oil prices emanates from geopolitical tensions in the Middle East that could lead to disruption of oil supply.*

[4] *In this instance, the rate of change in prices is associated with the variation in demand/supply conditions in the economy, influenced by a change in interest rates and the exchange rate. Technically, this relates to the net impact of changes in real interest rates and real exchange rates, referred to as "real monetary conditions", on the availability of credit and domestic industry competitiveness.*

2.4 *The Bank monitors the output gap[5] as a leading indicator of the direction of inflation resulting from factors that cause domestic demand to deviate from the economy's capacity to supply goods and services (long-term output trend). A sustained level of economic performance above trend is potentially inflationary and could signal the need to increase interest rates to dampen inflationary pressures, while output below trend could require a reduction of interest rates to stimulate economic activity. In general, the Bank will adjust monetary policy in response to a sustained deviation of the inflation forecast from the objective range, and where the causal factors could be influenced by domestic monetary policy action.*

2.5 *In this regard, the regular meetings of the Bank's Monetary Policy Committee (MPC) are directed at periodic and timely reviews of economic developments, related inflation outlook and the implications for the direction of monetary policy. The outcome of the MPC deliberations is disseminated to stakeholders immediately after each meeting in order to help anchor inflation expectations and contribute towards sustained policy credibility, which is critical in achieving long-term price stability.*

2.6 *The achievement of price stability supports international competitiveness of domestic producers through stabilising the real effective exchange rate (REER), in the context of the crawling band exchange rate policy. The REER is an inflation-adjusted composite exchange rate of the Pula (NEER), constituted by the South African rand (55 percent) and the SDR (45 percent). The weights used to determine the NEER or Pula basket reflect the estimated pattern of trade with South Africa and the respective SDR countries. In this respect, attaining inflation equal to that prevailing in trading partner countries would indicate that the competitiveness of Botswana producers is stable at the existing NEER. This is a key rationale for having a 3 – 6 percent inflation objective range, which approximates inflation in trading partner countries.*

2.7 *In the event that inflation in Botswana differs from that of trading partner countries, a stable REER can be attained by adjusting the NEER of the Pula to the extent of the inflation differential. This means that when Botswana's inflation objective is higher than the forecast average inflation of trading partner countries, there will be a downward crawl of the NEER in order to maintain international competitiveness of exports and domestic tradeable goods. Conversely, an upward crawl of the NEER will be implemented when the domestic inflation objective is lower than forecast average inflation of trading partner countries. It is important to emphasise that the best way of achieving durable improvement in international competitiveness of domestic producers is through gains in productivity, which contributes to lower inflation.*

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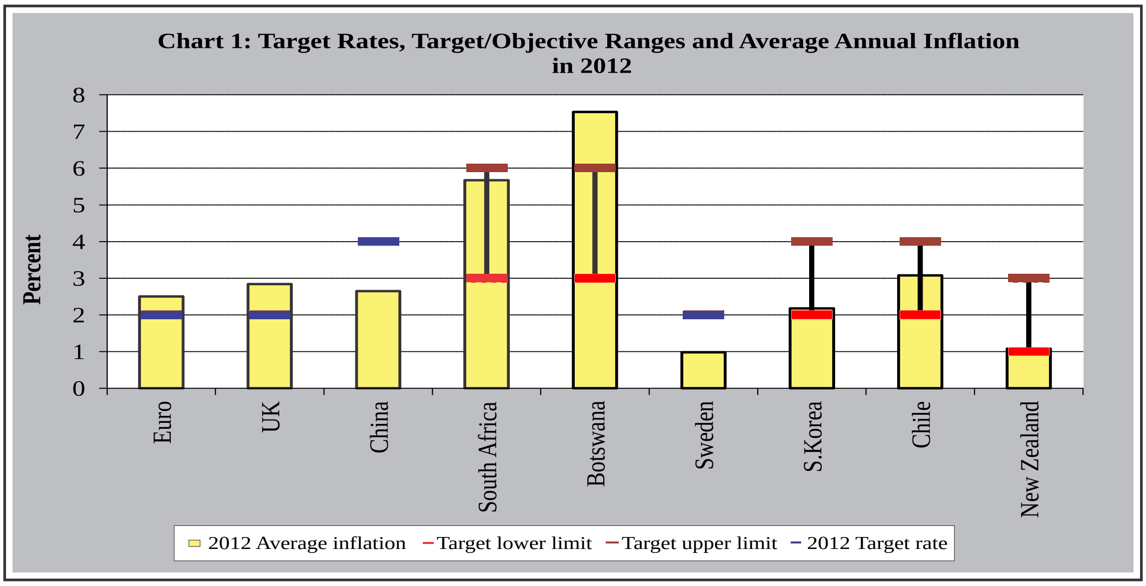
[5] *The output gap refers to the difference between long-term trend output (as an indicator of productive capacity) and actual output. A negative output gap means the actual level of output for a given period is below the trend level for that period, thus indicating the economy is operating below its estimated potential.*

2.8 Overall, the direction of both the REER and real interest rates, as measured by the real monetary conditions index (RMCI)[6], provides an indication of policy performance and the likely influence of monetary policy on inflation and economic activity. Therefore, an increase in real interest rates and/or an appreciation of the REER would indicate a tightening of monetary conditions that would serve to mitigate inflationary pressures, but this could result in a slowdown in economic activity. On the other hand, a decrease in real interest rates and/or a depreciation of the REER would imply a loosening of monetary conditions, which may be necessary to stimulate output growth; this could, however, be potentially inflationary.

3. INFLATION TRENDS AND OTHER ECONOMIC DEVELOPMENTS IN 2012

3.1 In the course of 2012, inflationary pressures were moderate in both developed and emerging market economies, thus reflecting modest growth in global demand and economic activity (Chart 1). In addition, persistent capacity underutilisation and high unemployment rates in major economies moderated the upward momentum of prices. Nonetheless, there were instances of significant upward pressure on prices, particularly in the early part of the second half of 2012, when grain prices rose significantly as a result of unfavourable weather conditions in major producing regions of the United States of America (USA) and Eastern Europe. International oil prices (US light crude) generally trended downwards although they were volatile, as reflected in the 7 percent decline between December 2011 and December 2012.[7] In this context, global inflation is estimated to have decreased from 4.5 percent in 2011 to 3.9 percent in 2012, as output growth weakened from 3.9 percent in 2011 to an estimated 3.2 percent in 2012.[8]



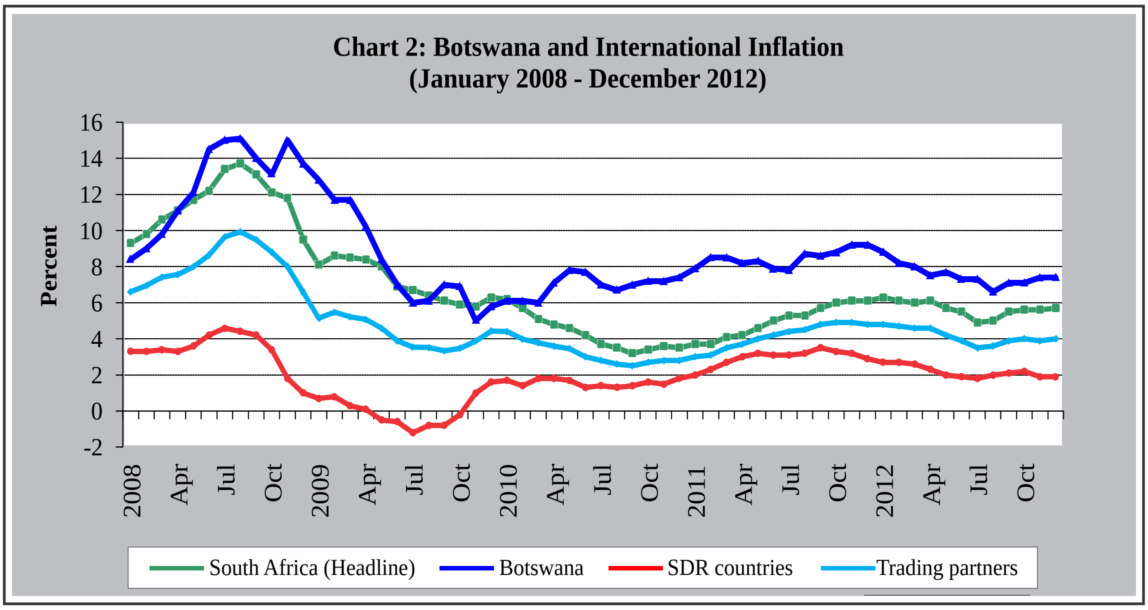
Source: Statistics Botswana

6 The real monetary conditions index (RMCI) measures the relative looseness or tightness of monetary conditions and gauges the likely effect that monetary policy has on the economy through changes in the exchange rate and interest rates. The real monetary conditions are measured by an RMCI that combines, through a weighted average, the deviations of the real exchange rate and real interest rate from their respective trend values.

7 Oil prices (US light crude) fell markedly in June 2012 to USD80 at the height of increasing concerns about prospects for the world economy and an increase in supply, before rebounding and stabilising at around USD90.

8 World Economic Outlook Update published by the International Monetary Fund (January 2013).

3.2 The trade-weighted average inflation for Botswana's trading partner countries declined from 4.8 percent in December 2011 to 4 percent in December 2012 (Chart 2).[9] For the SDR countries[10], inflation fell from 2.9 percent in 2011 to 1.9 percent in December 2012, mostly due to weak economic activity, lower food inflation and moderation in international oil prices.[11] The same factors accounted for the lower inflation in South Africa (6.1 percent in December 2011 to 5.7 percent in December 2012), which is within the country's medium-term target range of 3 – 6 percent.



Source: Statistics Botswana and other central banks

3.3 Inflation was above the Bank's medium-term objective range of 3 – 6 percent in 2012 (Chart 3), thus reflecting the impact of the increase in the cost of administered prices and the alcohol levy (Chart 5). On average, upward adjustments in administered prices added approximately 1.95 percentage points to inflation in 2012, with the annual increase in the cost of fuel alone contributing approximately 1.31 percentage points. However, restrained demand resulted in lower rates of increase in prices of other consumer items, thus holding down overall CPI inflation.

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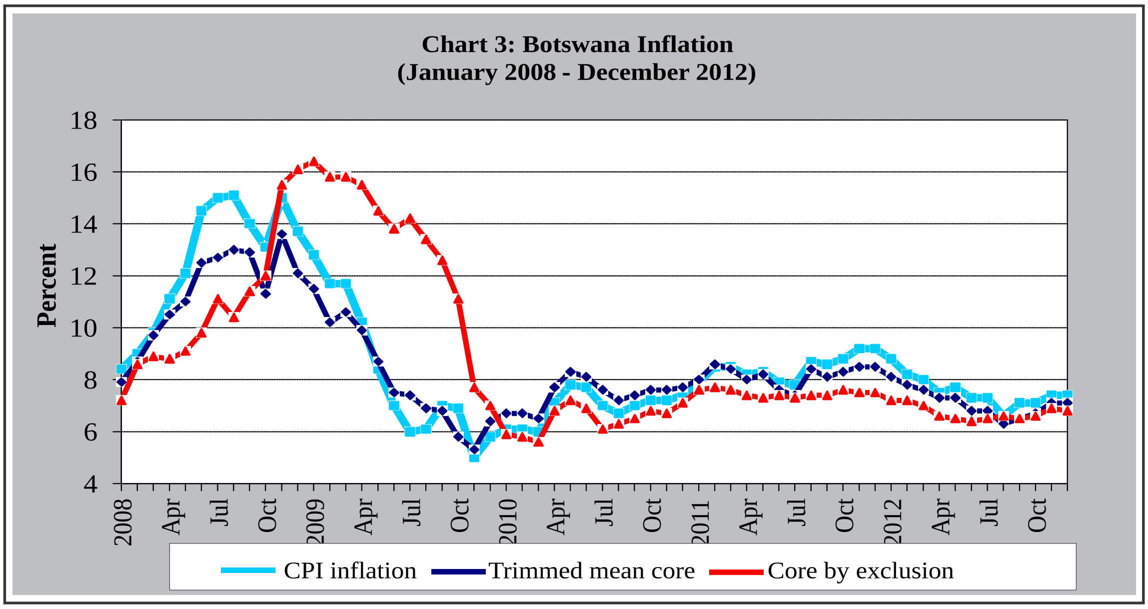
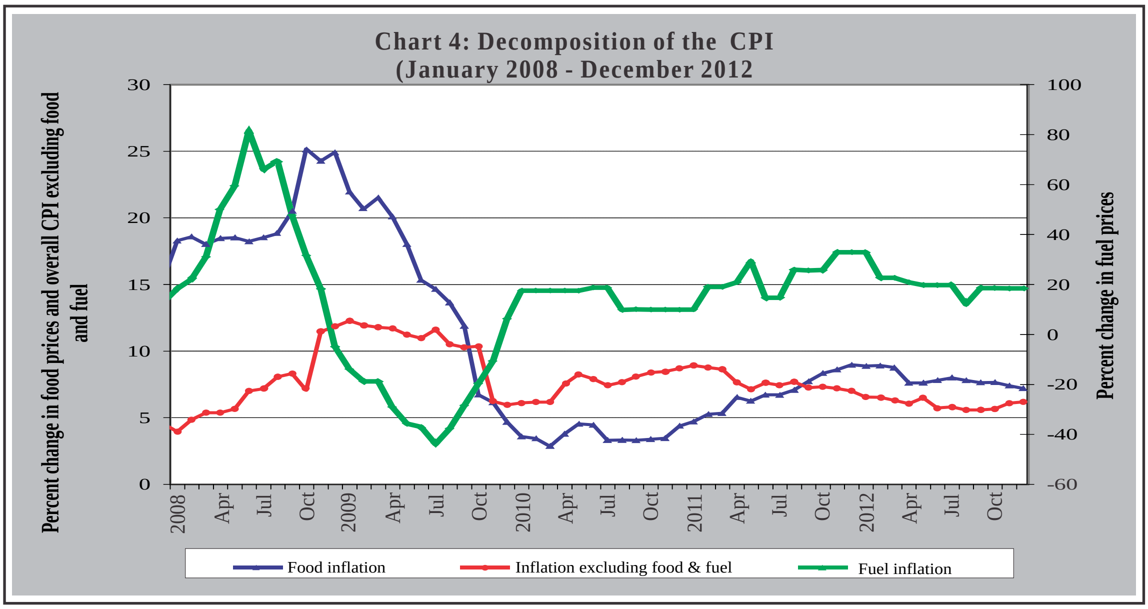
9 The trade-weighted average inflation comprises South Africa's headline inflation and the SDR countries' inflation.

10 USA, UK, Japan and the euro area.

11 Inflation declined in all the SDR countries (Japan is still experiencing deflation), with a more pronounced decrease in the second and the third quarters of the year.



Source: Statistics Botswana



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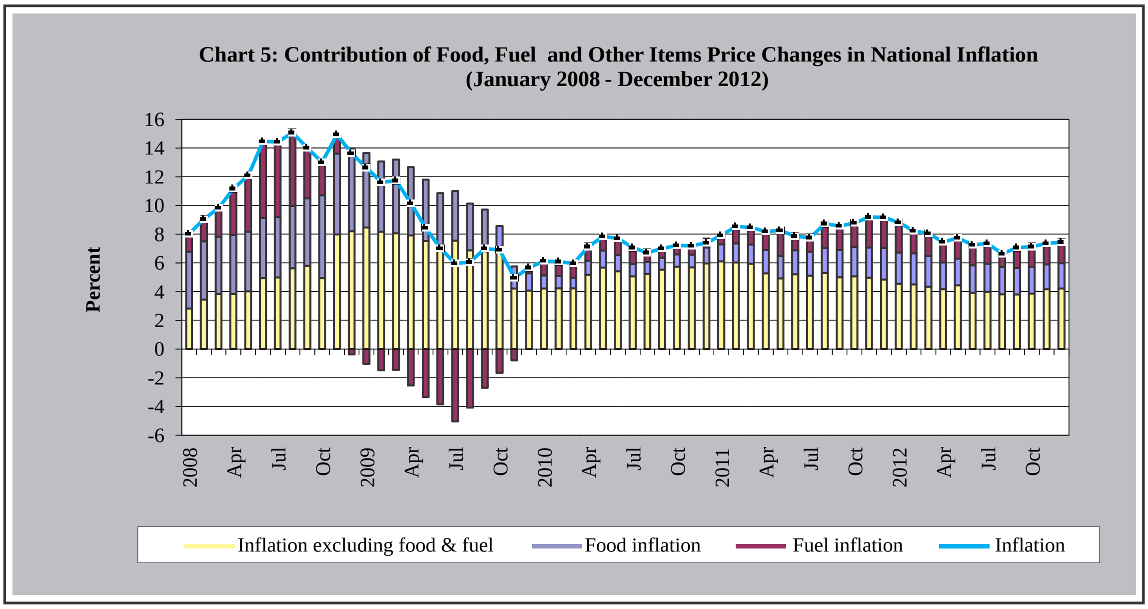

Source: Statistics Botswana

3.4 *Inflation fell from 9.2 percent in December 2011 to 6.6 percent in August 2012 (Chart 3), due to base effects associated with the previous year's increase in fuel prices, before rising to 7.4 percent in December 2012, given the increase in several administered prices in the second half of the year. Inflation excluding administered prices declined from 7.5 percent in December 2011 to 6.8 percent in December 2012, while the 16 percent trimmed mean measure of core inflation decreased from 8.5 percent to 7.1 percent in the same period.*

3.5 *Domestic demand pressures on inflation were benign in 2012 in an environment of below-trend domestic economic activity. In particular, household demand was constrained by the low growth in public sector wages*[12] *and an increase in administered prices, which had the effect of constricting discretionary spending. Given the focus on fiscal consolidation and balancing the budget, government expenditure growth, which included a 6 percent decline in development spending, was also modest, with a relatively lower stimulus impact on the economy.*

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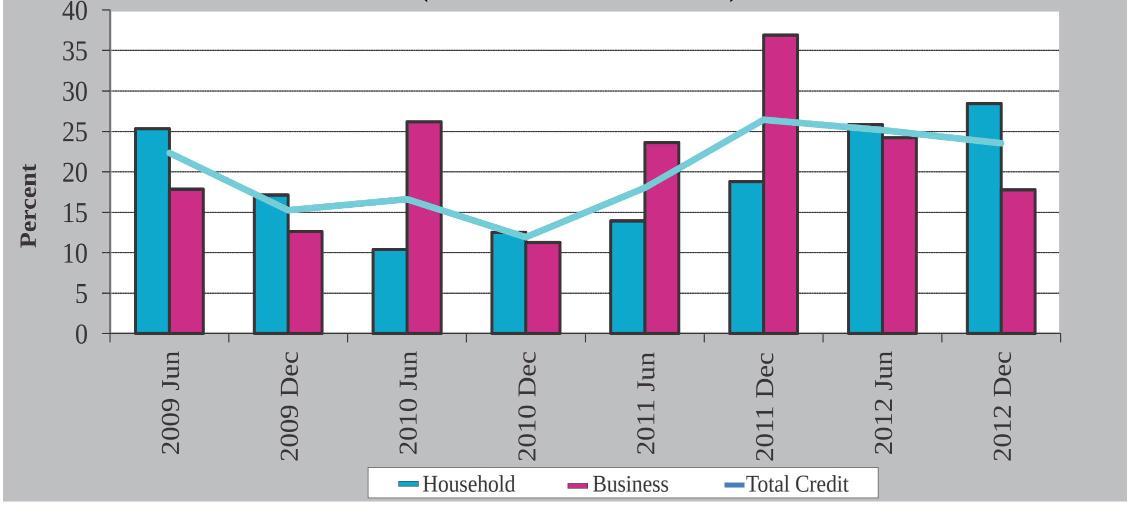
[12] *Public officers' salaries were increased by 3 percent effective October 2012.*

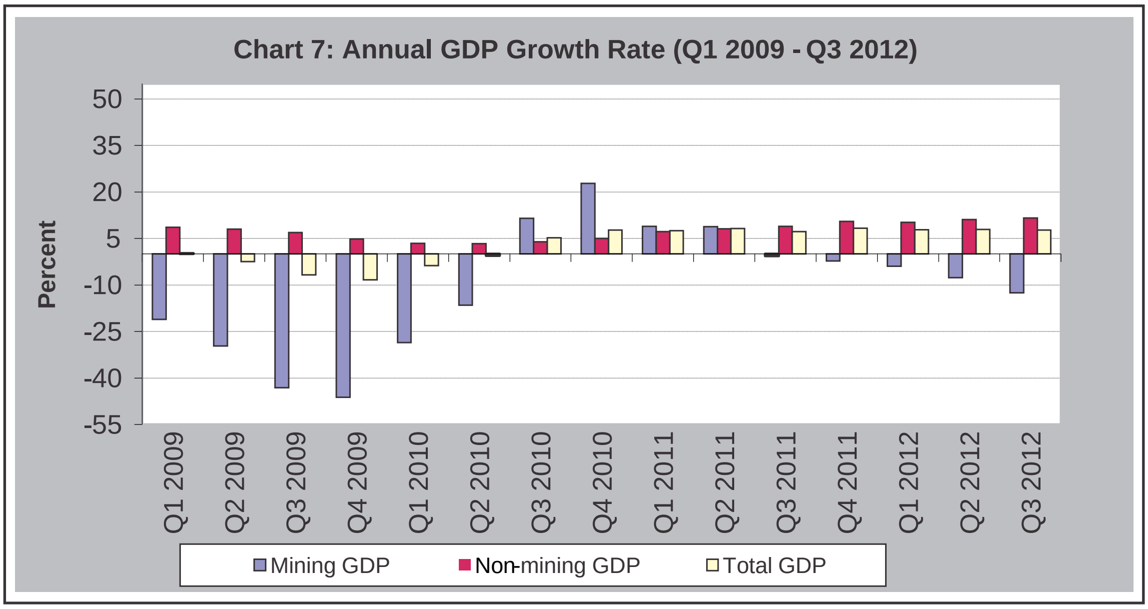
3.6 *Commercial bank credit expansion helped to stabilise aggregate demand as borrowing by households grew by 28.5 percent (from 18.8 percent in December 2011) in the twelve months to December 2012. Lending to businesses was also strong, with an annual increase of 17.8 percent, albeit lower than the 36.9 percent growth in 2011. Overall, year-on-year expansion in credit to the private sector decelerated from 26.4 percent in 2011 to 23.6 percent in 2012 (Chart 6). Therefore, credit growth and the decrease in government deposits at the Bank of Botswana were the main expansionary influence on money supply, which increased at an annual rate of 3.8 percent in November 2012 (4.4 percent in December 2011). In contrast, the 0.4 percent decrease in net foreign assets had a contractionary effect on money supply.*

3.7 *Money supply growth helped to support output expansion, which was estimated at 7.7 percent in the year to September 2012 (Chart 7), and compares with 7.3 percent for the corresponding period in 2011. Non-mining GDP increased by 11.6 percent in the year to September 2012, with notable contributions from construction (18.3 percent), financial and business services (12.6 percent), and transport and communication (11.6 percent). In contrast, mining output contracted by 12.5 percent compared to the previous year's decline of 0.7 percent.*

Chart 6: Household and Business Credit Annual Growth Rates (June 2009 - December 2012)



Source: Bank of Botswana



Note: The growth rate is calculated as the percentage change in cumulative GDP over four quarters over the corresponding period in the previous year.
Source: Statistics Botswana and Bank of Botswana calculations

4. IMPLEMENTATION OF MONETARY POLICY IN 2012

4.1 The conduct of monetary policy was characterised by threats to world economic performance due to difficulties experienced by some major economies, such as high debt levels, fiscal austerity, bank deleveraging (which tends to reduce lending) and weaker international trade. Moreover, persistent high unemployment rates and policy uncertainty in the USA and the euro area had an adverse impact on consumer and business confidence, with a negative impact on investment and demand. Efforts to improve growth prospects involved measures to alleviate credit constraints, structural reforms to foster competitiveness, fiscal consolidation plans and rescue packages for countries with severe debt problems. In the circumstance, growth in the world economy was driven mostly by robust performance of emerging market and developing economies.

4.2 In general, global inflationary pressures were moderate in 2012 because of weak economic activity, as manifested by low capacity utilisation and high rates of unemployment in major economies, while inflation expectations continued to be well anchored. Commodity prices were also stable in the context of a slack in international trade. Against this background, monetary policy stance was loose in 2012 in support of economic growth. Hence, major central banks, Federal Reserve Bank, Bank of Japan, Bank of England and European Central Bank, maintained low policy interest rates in 2012, alongside substantial provision of liquidity to the banking system. An accommodative monetary policy posture that began in late 2011 was also maintained in emerging market economies (notably Brazil, China and India) against a background of weaker external demand and concerns about the impact on domestic economic activity.

4.3 In Botswana, monetary policy was implemented in the context of below-trend non-mining output, which implied a negative (non-inflationary) output gap. Nonetheless, domestic inflation was above the 3 – 6 percent medium-term objective range because of transitory factors. In view of the positive medium-term inflation outlook associated with low demand pressures, below-trend economic performance (negative output gap) and benign external inflationary pressures, the Bank Rate was unchanged at 9.5 percent[13] in 2012. Similarly, the commercial banks' prime lending rate was kept at 11 percent during the year. However, the average commercial bank 88-day deposit interest rate fell from 4.08 percent in December 2011 to 3.52 percent in December 2012.

4.4 Monetary policy implementation was achieved through open market operations; excess liquidity was absorbed and interest rates maintained at levels consistent with the monetary policy stance. At the end of December 2012, the outstanding value of Bank of Botswana Certificates (BoBCs) was P8.7 billion, and this represented excess liquidity absorbed in the period. Reverse repos were used to mop up intra-auction liquidity. Movements in BoBC yields were marginal, with the 14-day BoBC yield rising from 4.5 percent in December 2011 to 4.64 percent in December 2012.

4.5 The Bank implemented a modest downward crawl of the Pula exchange rate in line with the policy objective of maintaining a stable inflation-adjusted exchange rate (REER) of the Pula against a trade-weighted combination of trading partner country currencies. As such, the Pula depreciated by 1.3 percent against the trade-weighted composite trading partner country currencies in the twelve months to December 2012. Overall, real monetary conditions, as measured by a combination of changes in the inflation-adjusted exchange rate and interest rates, were relatively restrictive in 2012 (Chart 10), thus contributing to moderate inflationary pressures. The accommodative negative real interest rates were more than offset by an appreciation of the REER of the Pula. Although the real 14-day BoBC rate was still negative, it increased from -4.3 percent in December 2011 to -2.57 percent in December 2012, thus reflecting the deceleration in inflation.[14] The downward crawl and the resultant depreciation of the NEER were smaller than the differential between inflation in Botswana and the average inflation of trading partner countries (Charts 11 and 12). Hence, the REER of the Pula appreciated by 1.9 percent in 2012, because of the inflation-raising effect of transient factors.

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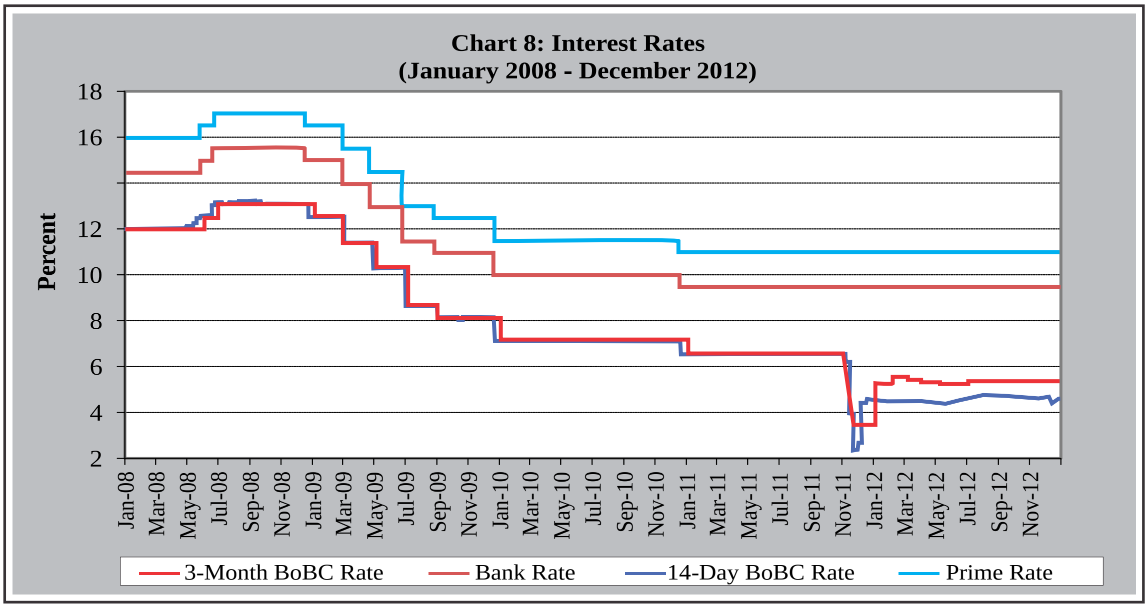
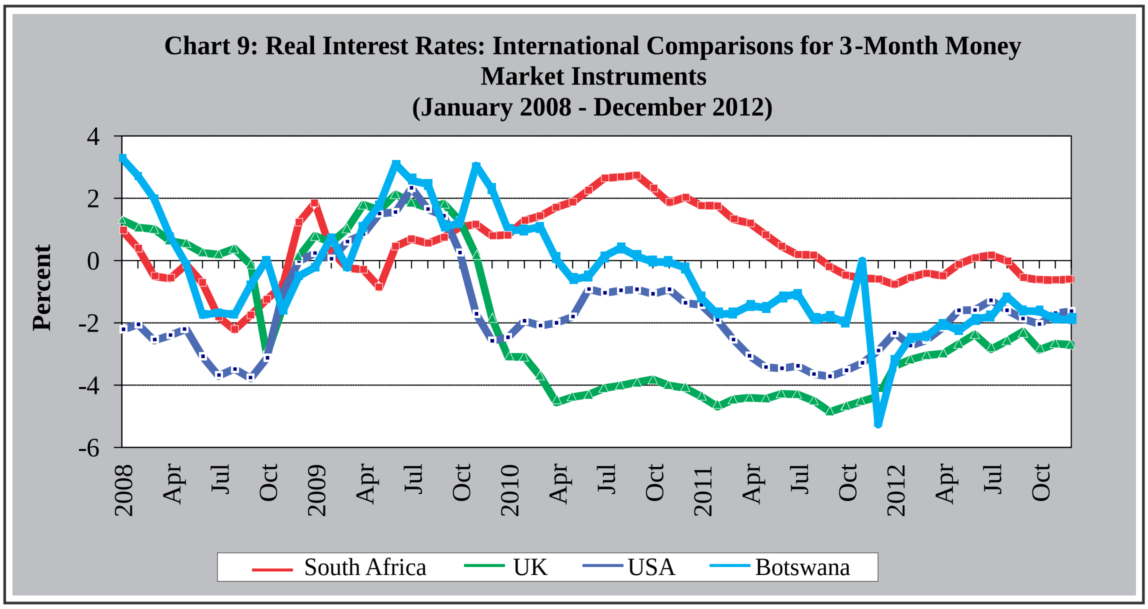
13 Unchanged since December 2010.

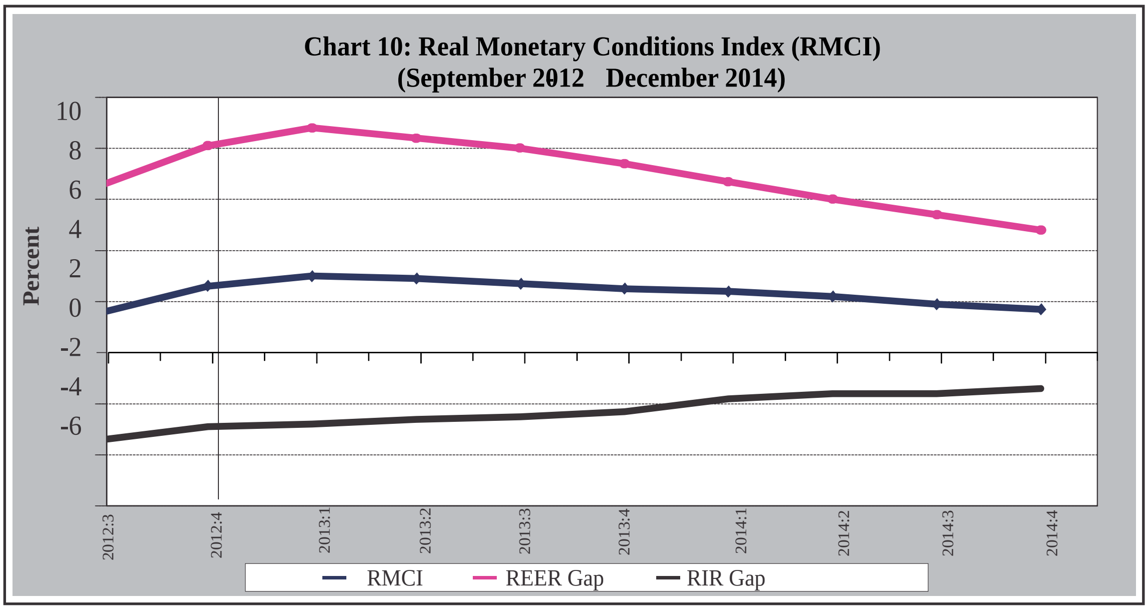
14 Real 3-month money market interest rates were -1.9 percent, -0.6 percent, -2.3 percent, -1.6 percent and -2.2 percent in December 2012 for Botswana (3-month BoBCs), South Africa, UK, USA and the euro area, respectively.



Source: Bank of Botswana



Source: Bank of Botswana



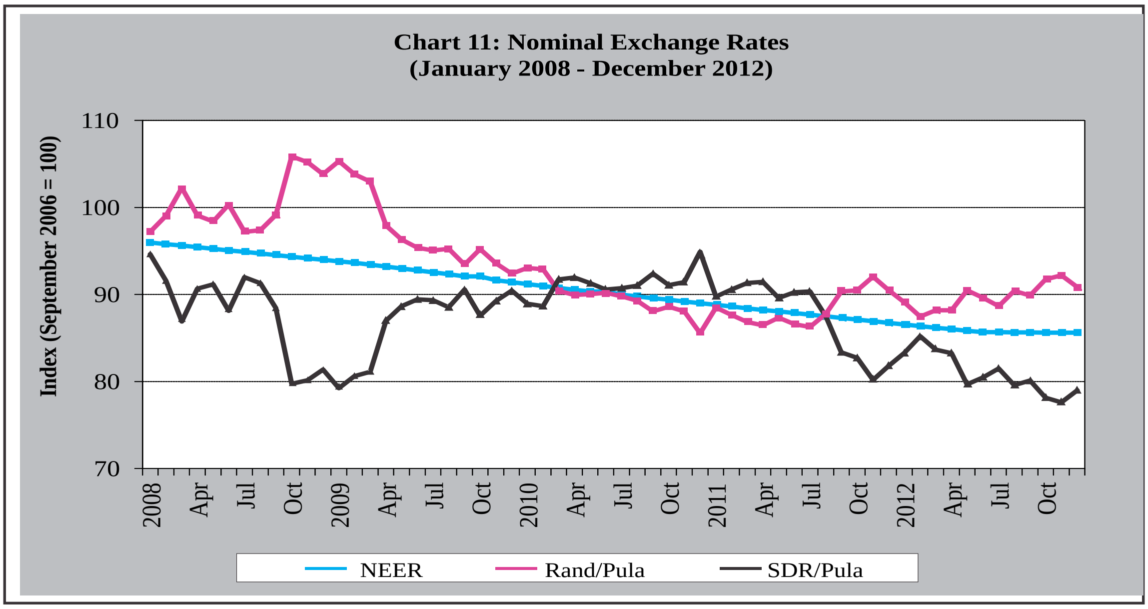
Source: Bank of Botswana

Notes:

(1) *REER Gap is a measure of the deviation of the actual REER from its trend value.*

(2) *Real Interest Rate (RIR) Gap is a measure of the deviation of the real interest rate (3-month real BoBC rate) from its trend value.*

(3) *The Real Monetary Conditions Index (RMCI) is a weighted average of the REER Gap and RIR Gap.*



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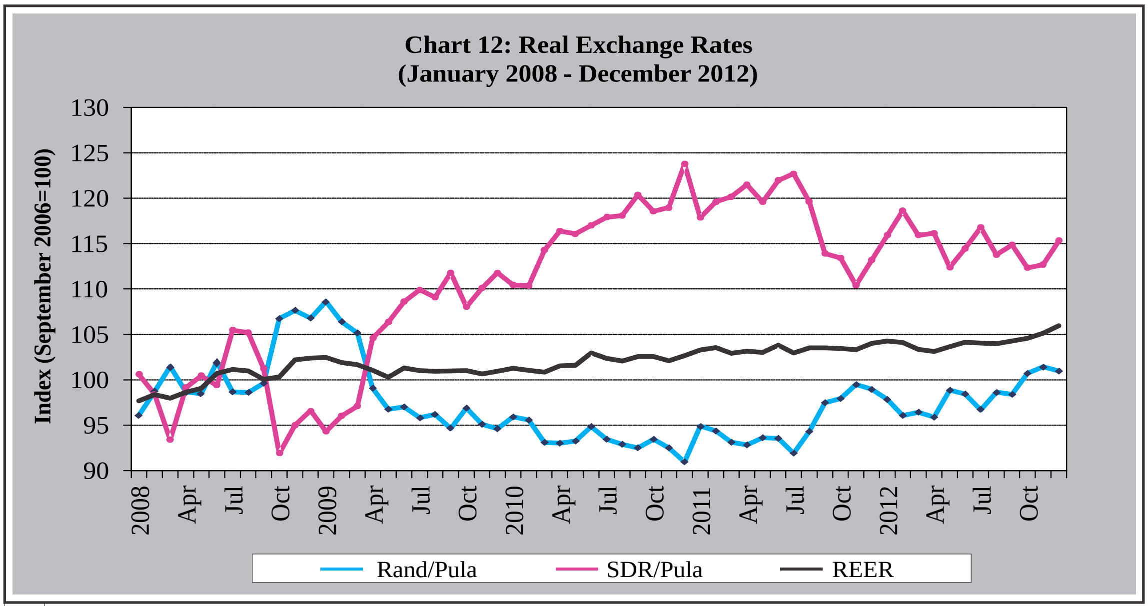


Source: Bank of Botswana

5. *OUTLOOK FOR INFLATION*

5.1 *Global output growth for 2013 is projected at 3.5 percent, which is slightly higher than the 3.2 percent estimate for 2012. This represents a downward revision from the earlier projection of 3.6 percent for 2013 and reflects increased uncertainty regarding the resolution of the euro area sovereign debt and the possibility of a renewed banking crisis. The USA authorities took initial steps towards averting the automatic onset of an increase in taxes and spending cuts (so called fiscal cliff) that were due at the beginning of 2013, thereby enhancing growth prospects. However, negotiations over spending cuts and the debt ceiling are ongoing and, if protracted, they could generate uncertainty, which would have a negative impact on economic activity. Nonetheless, indications are that the USA economy will continue to grow at a moderate pace (although below trend), while the euro area, Japan and UK are expected to either stagnate or be in recession. It is anticipated that buoyant economic activity in emerging market economies will continue to provide impetus to world output growth.*

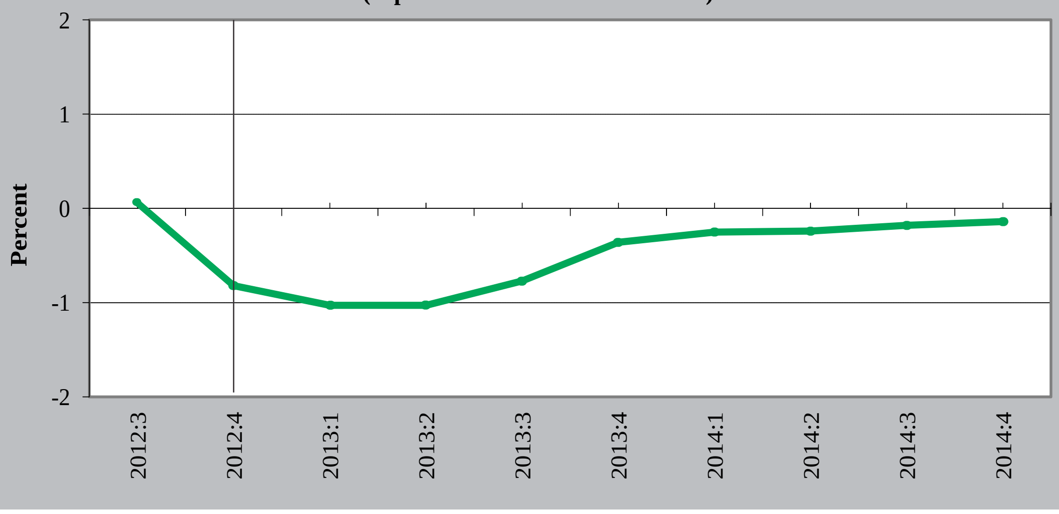
5.2 *The focus in major economies is expected to be on maintaining accommodative monetary policy, providing liquidity and fostering resilience of the financial sector to support the real economy. Medium- to long-term fiscal consolidation, productivity improvements and debt alleviation will have to be implemented concurrently. Similarly, it is expected that, given the moderation in growth, uncertain prospects for trade and low pressures on inflation, easy monetary policy will generally be maintained in emerging market and developing economies in 2013.*

5.3 *Global inflation is projected to moderate from 3.9 percent in 2012 to 3.7 percent in 2013 against the background of stable commodity prices, subdued global output growth, and persistence of spare capacity, including high rates of unemployment in major economies. However, there is upward pressure on inflation* *in some emerging market economies, given the robust economic activity and a lower rate of unemployment.*

5.4 *The 2013 projection for inflation in SDR countries is 1.8 percent (same as in 2012). Headline inflation in South Africa was 5.7 percent in 2012 and is forecast to average 5.6 percent in 2013. Given Botswana's medium-term inflation objective range of 3 – 6 percent and forecast average inflation range of trading partner countries of 3 – 5 percent, there will be a marginal downward crawl of the NEER of 0.16 percent in 2013. Therefore, it is expected that the influence of external price developments (through imported inflation and changes in the exchange rate) on domestic inflation will be minimal.*

5.5 *Output expansion for the domestic economy is forecast to be moderate at 5.9 percent for 2013, (from 6.1 percent in 2012), with a negative non-mining output gap (Chart 13)*[15] *and restrained activity in the context of anticipated modest local demand due to sluggish growth in personal incomes. In addition, construction activity is expected to ease, following robust performance in the past few years. Total government expenditure is budgeted to increase by 5.3 percent for the 2013/14 fiscal year, with development expenditure and recurrent expenditure increasing by 18.7 percent and 1.3 percent, respectively. There will be an overall budget surplus of P779 million. Notably, and unlike in the recent past, the extent of growth in development expenditure should provide some stimulus to the economy. Moreover, activity relating to the transfer of diamond aggregation to Botswana and downstream processing will be positive for growth across several sectors. Mining output will be determined by, in the main, new ventures, as existing producers are likely to either maintain or reduce their production levels in line with foreign demand.*

Chart 13: Botswana Non-Mining Output Gap
(September 2012 - December 2014)



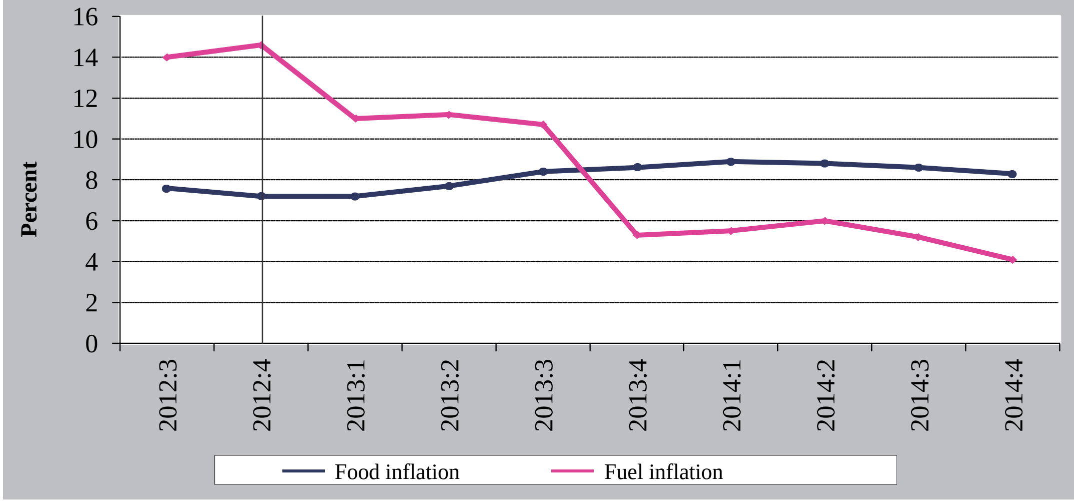
Source: Bank of Botswana

[15] *The projected negative output gap does not necessarily imply that output growth will be negative; rather, it means that actual output will be below trend level.*

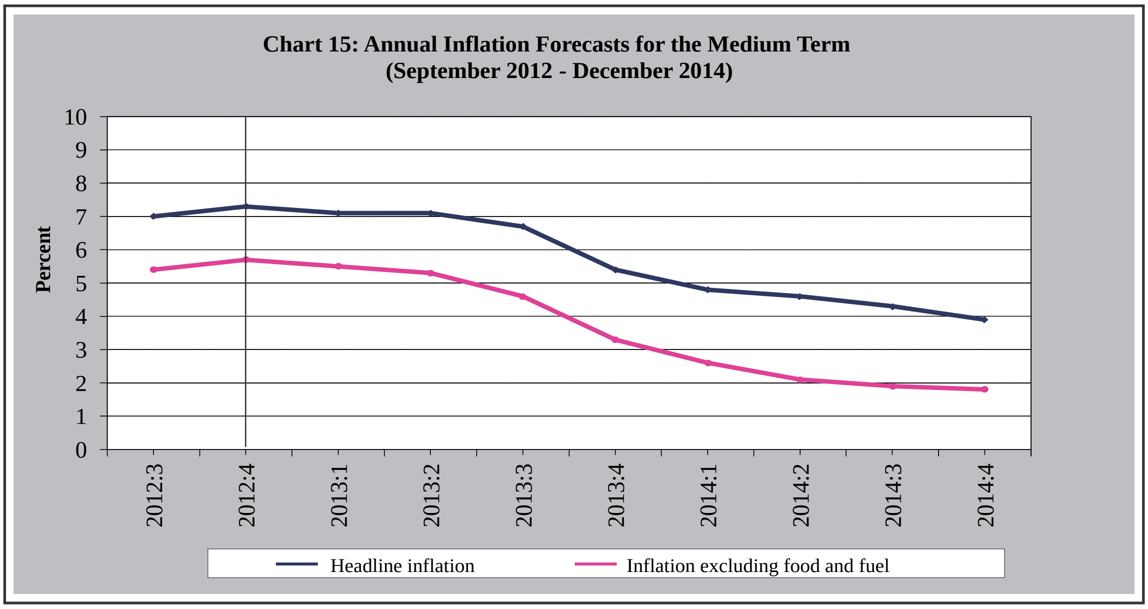
5.6 *The results of the Business Expectations Survey (BES) conducted by the Bank of Botswana in September 2012 show perceptions of improvement in economic prospects in 2013, with exporters more optimistic than domestic oriented firms. Economic growth expectations are in the range of 4.5 – 5 percent, which is somewhat lower than the official estimate of 5.9 percent. Inflation expectations have stabilised, although at levels above the 3 – 6 percent medium-term objective range.*

5.7 *Taking account of the projected below-trend economic activity and modest growth in disposable incomes, it is expected that domestic demand pressures on inflation will be low in 2013, as will the impact of benign foreign price developments on domestic inflation. Therefore, inflation is forecast to remain above the medium-term objective range of 3 – 6 percent in the short term and to fall within the range later in the year (Chart 15). However, any substantial upward adjustment in administered prices and government levies and any increase in international food and oil prices beyond current projections (Chart 14) present upside risks to the inflation outlook. There are also downside risks arising from the weaker global economic activity that could lead to lower inflation than currently projected.*

Chart 14: Domestic Fuel and Food Inflation Forecasts for the Medium Term (September 2012 - December 2014)



Source: Bank of Botswana



Source: Bank of Botswana

6. 2013 MONETARY POLICY STANCE

6.1 In view of the current monetary policy stance and the forecast influence on price developments, it is anticipated that domestic inflation will converge to the medium-term objective range of 3 – 6 percent in the second half of 2013. This is against the background of restrained underlying demand pressures and projected below-trend output growth. The outlook for low and stable inflation in the medium term suggests an accommodative monetary policy stance, which would be supportive of economic activity.

6.2 It is important to note, however, that persistent inflation above the medium term objective range presents a challenge for monetary policy implementation, as inflation expectations may have an upward bias. Therefore, the formulation and implementation of monetary policy will need to take into account the impact of short-term price developments on inflation expectations, which could potentially feed into medium-term expectations and the level of inflation. Accordingly, the Bank will respond in a timely manner to any sustained deviation of forecast inflation from the medium-term inflation objective range of 3 – 6 percent, in order to engender expectations of a low and predictable level of inflation.

6.3 The Bank's implementation of the exchange rate policy for 2013 will entail a modest downward crawl of the nominal Pula exchange rate of 0.16 percent, because the inflation objective is marginally higher than average inflation of trading partner countries. The crawling band exchange rate policy is in the best interest of international competitiveness of domestic industries and could contribute towards sustainable economic diversification.

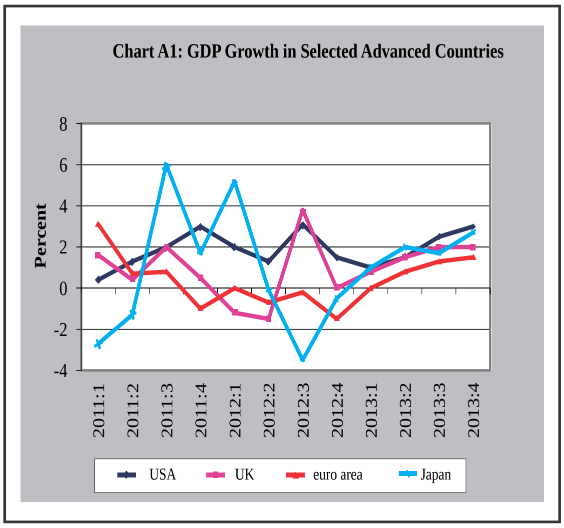
7. CONCLUSION

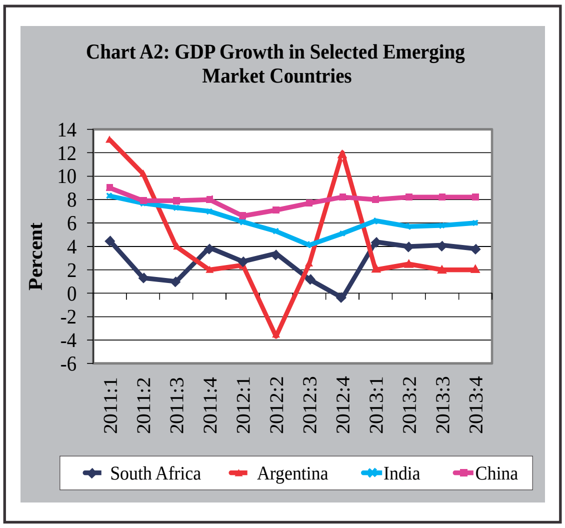
7.1 The global economic recovery is on course, albeit at a slower pace and is subject to considerable downside risks. This is on account of the uncertain prospects of resolving the euro area debt situation and fiscal policy challenges in the USA. In the short term, economic activity is negatively affected by the ongoing fiscal consolidation measures, weak consumer and business confidence, as well as higher unemployment in major economies. In the medium term, the world economy is expected to be strengthened by improved financial conditions and accommodative monetary policy in both advanced and emerging market economies. Meanwhile, global inflation is expected to remain largely restrained as a result of easing international commodity prices and the weak global economic performance.

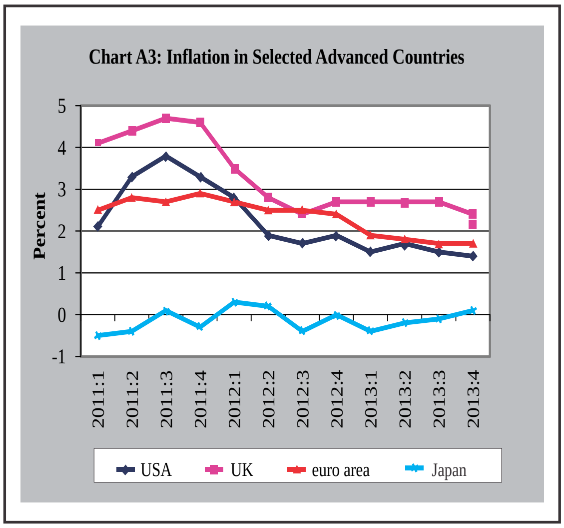
7.2 Domestic inflation is forecast to remain above the medium-term objective range of 3 – 6 percent in the short term; it is expected to fall within the range later in 2013 in the context of low domestic demand, benign external price developments and base effects. In the circumstances, the Bank's formulation 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. The Bank remains committed to responding appropriately to all economic and financial developments to attain price stability in the medium term, without jeopardising sustainable economic growth.

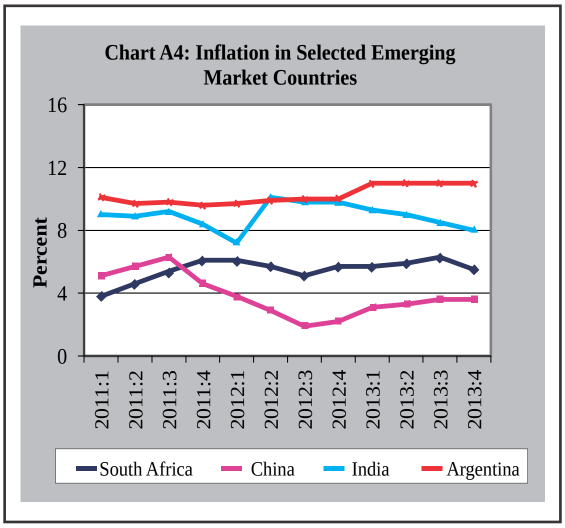
Appendix

Output Growth and Inflation for Selected Countries









Source: JP Morgan Chase

Note: Data from Q4 2012 to Q4 2013 are forecasts.