BANK OF BOTSWANA

MONETARY POLICY STATEMENT - 2005

1. INTRODUCTION

1.1 The aim of the monetary policy of the Bank of Botswana is to achieve and maintain monetary stability, defined as a low and sustainable rate of inflation. It is the principal way in which the Bank contributes to the broader national objective of improving the economic well-being of the nation. The annual Monetary Policy Statement affords the Bank an opportunity to report on inflation and monetary developments during the previous year, and to present its assessment of the inflation outlook for the current year. It also contains the Bank's annual objectives for inflation and an explanation of how these are derived in the context of the Bank's monetary policy framework. The Statement outlines the approach that the Bank will take in formulating its policy response to inflation-related developments throughout the year. Therefore, the Monetary Policy Statement has a significant role in conveying to stakeholders and the public at large a range of information relating to inflation and monetary developments as well as the formulation and implementation of monetary policy.

1.2 Consistent with past practice, the 2005 Monetary Policy Statement reviews developments in inflation in the previous year and their underlying causes, and assesses the extent to which monetary policy was successful in meeting its objectives. This is followed by a presentation of the Bank's analysis of prospective developments during 2005 and, based on that, the policy outlook for the current year.

1.3 In summary, the Statement concludes that higher prices following the devaluation of the Pula in February and increases in administered prices were the primary sources of the upward pressure on inflation in 2004. Consequently, while inflation was within the objective range of 4 – 7 percent for most of the year, it breached and remained slightly above the upper limit in the fourth quarter. Domestic demand pressures were moderate, partly due to the lower rate of fiscal expansion and the restrictive stance of monetary policy, both of which resulted in reduced private sector credit demand. While global economic activity improved and there were added inflationary pressures due to historically high oil prices, external inflationary pressures were generally benign. Looking ahead, global inflation is expected to remain low due to pre-emptive monetary policy tightening in some of the major industrial countries and continued strong competitive pressure in goods markets internationally. Domestic demand pressures are expected to remain subdued in the context of the continuing moderate expansion in government expenditure and private sector credit growth. Therefore, assuming no further substantial increases in administered prices, chances are good that the upward trend in inflation experienced in 2004 will be reversed in 2005. The task for monetary policy in the circumstances will be to ensure that any deceleration in the rate of price increases is durable and consistent with the Bank's inflation objective.

2. MONETARY POLICY FRAMEWORK AND OBJECTIVES

2.1 The principal objective of monetary policy in Botswana is to achieve and maintain a sustainable, low and predictable level of inflation that, along with other policies, will contribute towards broader national objectives of durable economic growth. In particular, the Bank's objective of low inflation supports the maintenance of international competitiveness of domestic producers. In the short term (normally on an annual basis), this latter objective can be achieved by monetary policy aiming for a domestic inflation rate that is, in general, no higher than the average inflation of its major trading partners, after taking account of any change in the nominal effective exchange rate of the Pula. The current policy framework seeks to achieve this domestic inflation objective while at the same time maintaining a pegged nominal exchange rate. This policy combination is feasible in the context of limited international capital flows and the present embryonic development of domestic financial markets.

2.2 In pursuing its inflation objective, the Bank uses interest rates to moderate inflationary pressures in the economy. This is achieved indirectly through the impact of interest rates on credit that, in turn, affects large components of domestic demand. Changes in interest rates, along with other policies, especially fiscal and exchange rate policies, affect the overall level of demand for goods and services in the economy relative to a given level of output. Inflationary pressures are generated when aggregate domestic expenditure exceeds the supply of available goods and services.

2.3 In deciding on its monetary policy stance within this framework, the Bank closely examines the sources of changes in inflation. Monetary policy responds primarily to changes in inflation that are due to domestic demand pressures rather than those that are due to transitory factors, discrete adjustments of administered prices, or supply fluctuations over which monetary policy has no direct influence. In recognition of this limitation, the Bank closely monitors a measure of core inflation in addition to headline inflation published by the Central Statistics Office[1]. This enables analysis of the underlying inflationary trends that are most relevant for monetary policy; while the inflation objective is assessed in terms of headline inflation, core inflation is used to evaluate the reasons for any volatility or divergence from the inflation objective.

2.4 In implementing monetary policy, the Bank focuses on the rate of growth of commercial bank credit to the private sector as an intermediate target, given that it is the main contributor to the growth of private consumption and investment and can be directly influenced by monetary policy through changes in interest rates. The growth rate of government spending is also an important determinant of domestic demand, since a large proportion of this demand is derived from expenditure on public consumption and investment. While the Bank can affect private sector demand through monetary policy, the continuing significant role of

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[1] *The Bank's preferred measure of core inflation is based on the trimmed mean approach. This approach removes the most extreme price changes, regardless of their source. The core inflation rate is currently calculated by the Bank from data published by the Central Statistics Office.*

the Government in the economy underscores the need for complementarity between fiscal and monetary policies in achieving the inflation objective.

3. INFLATION TRENDS IN 2004

3.1 World economic activity strengthened in 2004 and global inflation rose, partly due to pressure from higher oil prices. Some of the major central banks reacted by tightening monetary policy in an attempt to pre-empt inflationary pressures and to sustain expectations of low inflation. In Botswana, domestic demand pressures eased considerably as growth in both credit and government expenditure was below the ranges considered to be consistent with the inflation objective. However, despite subdued demand, inflation prospects were negatively influenced by higher costs arising from the 7.5 percent devaluation of the Pula in February 2004 and substantial increases in administered prices, including fuel.

3.2 As a result of the devaluation and the increases in administered prices, annual inflation maintained an upward trend in 2004, rising from 6.4 percent in December 2003 to 7.8 percent in December 2004. It is estimated that the 7.5 percent devaluation contributed about 2 percentage points to inflation during 2004, mostly as a result of higher Pula-denominated import prices[2]. The decline in South African inflation in the second half of the year helped mitigate somewhat the impact on domestic prices.

3.3 The substantial increase in international oil prices necessitated several upward adjustments of fuel prices by the Government during the year, cumulatively adding 1.3 percentage points to inflation. In addition, the substantial upward adjustment of transport fares and some telephone charges contributed 0.9 percentage points to inflation. Overall, inflation, excluding items with administered prices[3] is estimated to have been between 5.5 percent and 6 percent in 2004, well within the 4 – 7 percent objective. Core inflation also rose during the year, from 6.7 percent in December 2003 to 7.7 percent in December 2004, signifying a generalised trend increase in the rate of price increases for items in the consumer price index basket.

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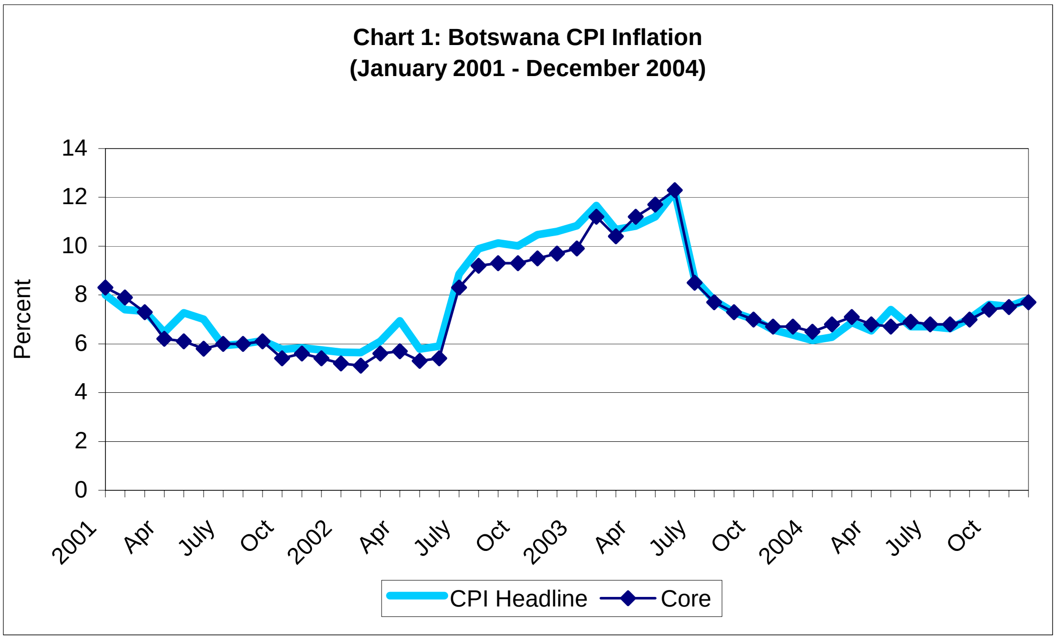
2 *This is based on an assumption that without the devaluation and other exceptional items, such as the increase in fuel prices, the rate of increase in prices of imports would have been the same or lower (especially given lower South African inflation) in 2004 compared to 2003.*

3 *About 16 percent of items in the consumer price index basket have prices that are administratively set by the Government and various parastatals outside the normal free market price determination. It is recognised, however, that these price adjustments are influenced to some degree by general price developments. The cost adjustments are justified as a way of catching up with market prices, a response to higher input costs and a move towards cost recovery, while fuel price adjustments are done in response to international oil price developments. However, these price changes are not directly influenced by policy, hence, monetary policy will not normally respond to them, except to the extent that they are expected to influence " free" prices, especially through second round effects.*



4. *INFLUENCES ON DOMESTIC INFLATION IN 2004*

4.1 Global economic performance improved in 2004, following weaker activity in 2003, and was led by growth in China and the USA. World GDP is estimated to have grown by 5 percent in 2004 compared to 3.9 percent in 2003[4]*. Inflation in the major industrial countries (Chart 2) rose slightly in 2004, from 1.7 percent in 2003 to 2.6 percent, and was significantly influenced by the rise in international oil prices. In South Africa, after rising slightly in the first half, inflation resumed its downward trend in the second half of 2004, largely due to the strengthening of the rand, and remained within that country's 3 – 6 percent target range. The combined effect of all these developments was that average inflation for Botswana's trading partners rose during 2004, from 3.2 percent in December 2003 to 3.7 percent by year-end.*

4.2 Real GDP growth in Botswana continued to grow strongly in the national income accounting year 2003/04[5]*, although at a slower pace than during the previous year. Growth was an estimated 5.7 percent compared to a revised 7.8 percent in 2002/03. The slowdown was mainly in non-service sectors, in particular mining and water and electricity, as well as manufacturing where output contracted. Mining output, which had risen by 10.3 percent in 2002/03, grew less rapidly at 6.9 percent in 2003/04, while water and electricity production expanded by 3.9 percent compared to nearly 10 percent in the previous year. With the improved performance of the service sector partially offset by the slower growth of the industrial sector, the pace of non-mining output growth fell from 6.4 percent in 2002/03 to 5.1 percent in 2003/04. Overall, however, the 5.7 percent rate of*

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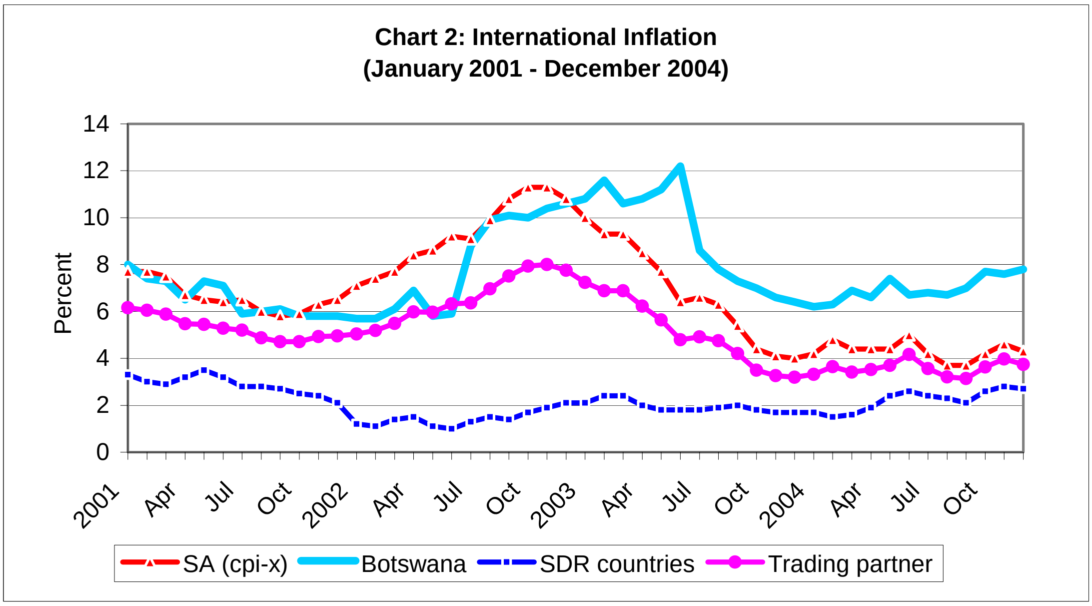
4 *All estimates for the global developments are drawn from the International Monetary Fund's World Economic Outlook reports.*

5 *The national income accounting year runs from July to June*

growth was close to the projected average annual growth of 5.5 percent for the period of the ninth National Development Plan (NDP 9).

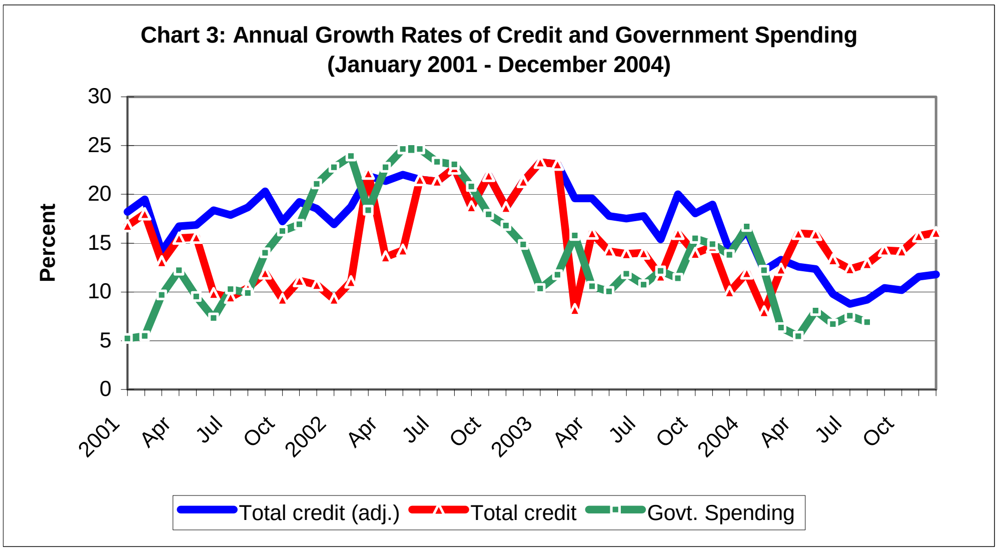


SDR countries are the USA, UK, Japan and euro zone

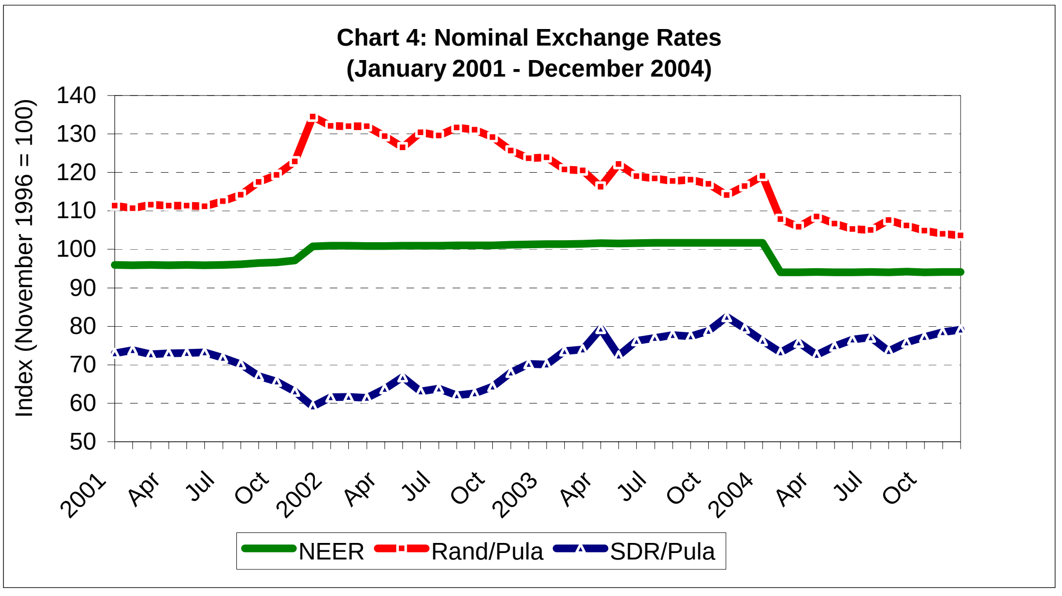
4.3 *The twelve-month growth in commercial bank credit decreased from 14.2 percent in December the previous year to 11.8 percent in December 2004, and compared to the Bank's intermediate target for credit growth of 12 – 14 percent. The slowing occurred in the context of a tight monetary policy as well as a restrained rate of growth in government expenditure. However, the 15 percent average increase in public service salaries earlier in the year contributed to a doubling of the annual growth of credit to households, from 10.9 percent a year earlier to 21.7 percent in December 2004. The increase came despite the modest erosion of real wages over the preceding two years, increasing debt levels, and the increase in prices following the devaluation. Business credit, on the other hand, grew by only 0.2 percent, year on year, with demand subdued by the slower increase in government spending during the year and more moderate business activity generally.*

4.4 *Total government recurrent and development expenditure rose by an estimated 10.2 percent in the fiscal year 2004/05, moderately higher than 8.9 percent of 2003/04 but within the range considered to be consistent with the inflation objective. As such, fiscal policy has been generally supportive of monetary policy in an environment in which inflation was rising above the objective range.*

4.5 *In the twelve months to December 2004, the Pula depreciated in nominal terms against most major international currencies as a result of the 7.5 percent devaluation of the currency in February. The trade-weighted nominal effective exchange rate (NEER), which depreciated by the extent of the devaluation, has since been stable. Against individual currencies, the Pula depreciated by 0.5* *percent in nominal terms against the SDR[6] over the 12 months to December 2004, which included a 3.7 percent appreciation against the US dollar, while it was 11 percent weaker vis-à-vis the rand. Although the real effective exchange rate (REER) initially fell by 7.5 percent following the devaluation, it was, by the end of the year, only 4.5 percent lower as a result of higher inflation in Botswana compared to that in trading partner countries. Bilaterally, the real exchange rate of the Pula was 8.4 percent weaker against the rand but had appreciated by 4.3 percent against the SDR.*



The adjustment of credit growth figures reflects the exclusion of exceptional items unrelated to underlying credit growth.



In Charts 4 and 5, a rise in the index indicates an appreciation of the Pula.

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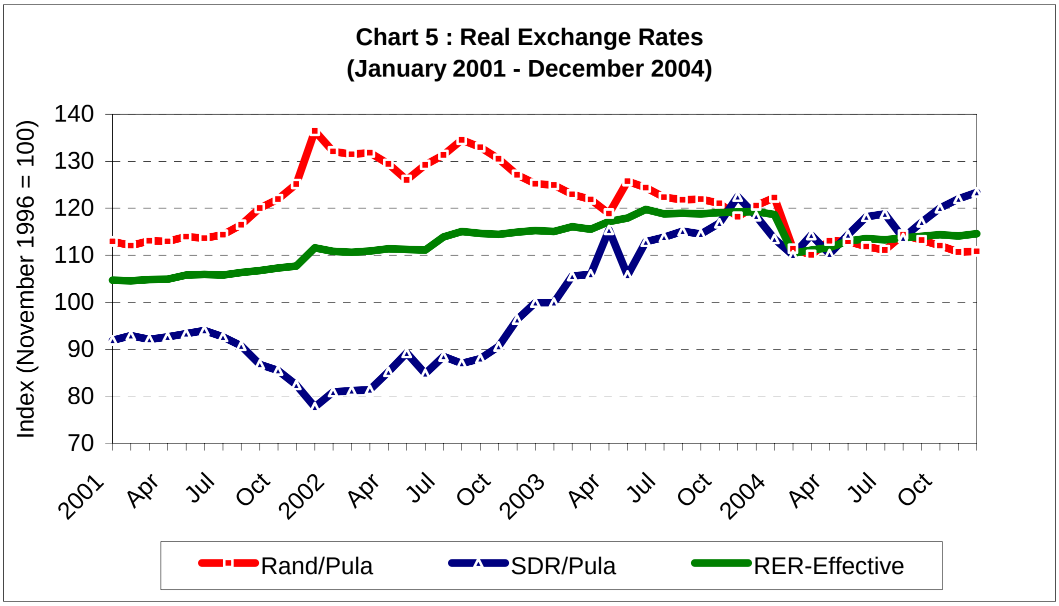
6 *The SDR is a composite unit of account or currency comprising the US dollar, British pound, euro and Japanese yen.*



5. MONETARY POLICY DURING 2004

5.1 The Bank's inflation objective for 2004 was 4 – 7 percent. With this objective the Bank sought to influence and sustain expectations of low inflation in an environment in which inflation pressures rose following the February 2004 devaluation of the Pula. The upper limit of the 2003 inflation objective of 4 - 6 percent, was raised from 6 percent to 7 percent to allow room for the economy to adjust to the increase in imported inflation arising from the devaluation, while the widening of the range was to accommodate the expected increase in inflation volatility and the desire to bring inflation down on a gradual and steady path. The higher upper limit nevertheless implied that domestic inflation would possibly end the year higher than that of trading partners, and thus recognised that the gain in competitiveness from the devaluation would be partly offset by the higher inflation generated by it. In the circumstances, although inflation trended upward and rose above the upper end of the objective range, it was expected to eventually fall in response to subdued demand as well as external price and exchange rate developments. The monetary policy stance was, nevertheless, unchanged in 2004 in order to sustain expectations of an eventual decline in inflation to low and sustainable levels[7].

5.2 While inflation in Botswana rose to levels above the Bank's desired range in the latter part of the year, the annual rate of price increase also rose in trading partner countries, albeit at a much slower rate; trading partner inflation was 3.7 percent by the end of December 2004[8]. Despite relatively high inflation, Botswana's REER decreased by 4.5 percent as the 7.5 percent nominal devaluation of the currency in

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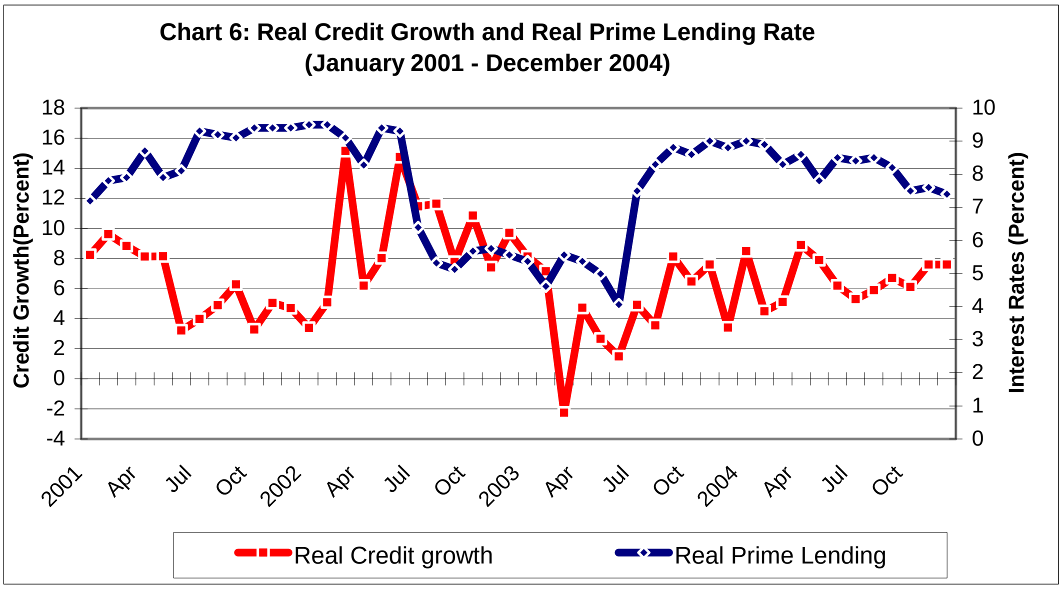
7 *The Bank Rate was last changed in 2003, when it was lowered by 50 basis points in October and a further 50 basis points in December to its current level of 14.25 percent.*

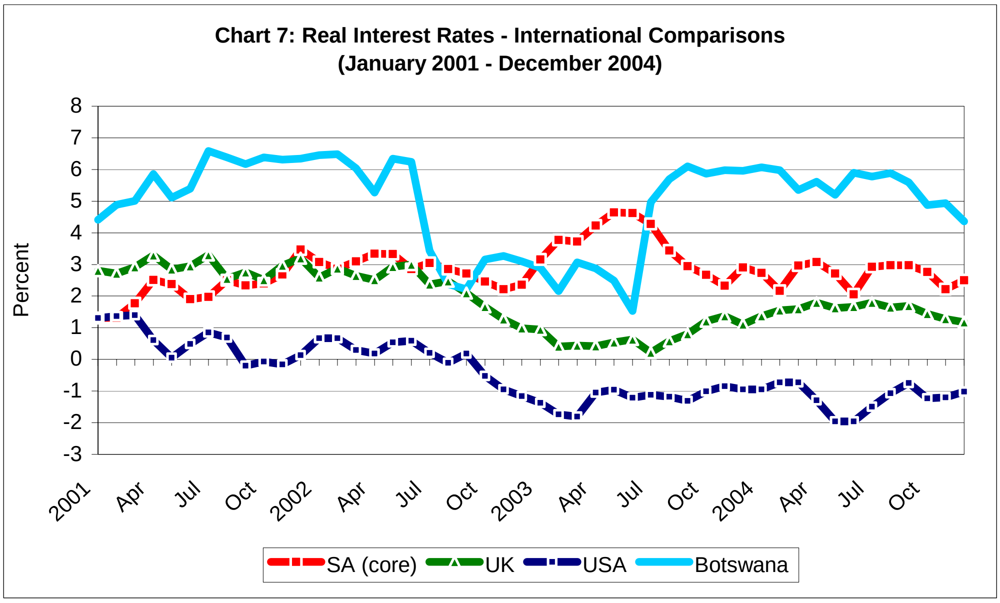
8 *This is lower than forecast at the beginning of 2004, due entirely to lower inflation than forecast in South Africa. Inflation in SDR countries was higher.*

February was partially offset by the increase in inflation since the devaluation. This illustrates and underscores the fact that lasting international competitiveness of domestic producers can be achieved only with economy-wide improvements in productivity and lower inflation vis-à-vis trading partners. The Bank's focus on bringing inflation down to low and sustainable levels over time reflects both the national objective of export-led economic growth and the Bank's own statutory objective of achieving and maintaining monetary stability.

5.3 *The Bank's open market operations were conducted during the year to ensure that short-term interest rates, in particular yields on Bank of Botswana Certificates (BoBCs), were consistent with its monetary policy stance. A shorter-term (14-day) BoBC was introduced in November to increase the effectiveness and lower the costs of market operations. The new BoBC will also enhance liquidity in the short-end of the domestic money market. The 91-day (3-month) BoBC will continue to be auctioned, although in smaller quantities.*

5.4 *The Bank's lending rate (Bank Rate) was unchanged during the year at 14.25 percent resulting in generally stable deposit and lending rates at commercial banks. The average 88-day deposit rate remained in a narrow range around 9.2 percent for most of the year, while the prime-lending rate remained at 15.75 percent. Real interest rates fell, however, reflecting the higher inflation. The real three-month BoBC mid rate fell from 6.1 percent in January and 5.9 percent in June to 4.4 percent in December. As at the end of December, the real commercial bank prime lending rate was 7.4 percent. Real interest rates in Botswana continue to be higher than comparable rates in major overseas economies and South Africa (Chart 7).*





6. OUTLOOK FOR INFLATION IN 2005

6.1 Global economic activity is expected to slow moderately in 2005, with forecast GDP growth of 4.3 percent compared to an estimated 5 percent in 2004. The sharp rise in oil prices, which contributed to a weakening of global demand expansion towards the end of 2004, is expected to have a similar effect in 2005. However, after increasing to record levels in 2004, oil prices had eased by year-end, in part due to the Organisation of Petroleum Exporting Countries' (OPEC) commitment to keep prices at sustainable levels through output expansion, but remain high. Despite these upward pressures on prices, inflation is generally under control due to productivity growth and continued strong competition in goods markets. Labour market pressures are also subdued and pre-emptive monetary policy tightening in some countries is having an effect. In the circumstances, average inflation in SDR countries is forecast to decline from 2.6 percent in 2004 to about 2 percent in 2005.

6.2 Inflation in South Africa, which is one of the more important external influences on inflation in Botswana, is expected to remain within the target range over the medium-term. Interest rates could rise, however, in response to accelerating credit growth, a widening current account deficit and any further significant weakening of the rand.

6.3 In Botswana, it is expected that domestic demand pressures will continue to be restrained in 2005, particularly in the context of budgeted moderate growth in government expenditure which, in turn, will help sustain current levels of credit growth considered to be consistent with the inflation objective. Furthermore, it is anticipated that the absence of a salary increase for civil servants will restrain household borrowing which, in 2004, was the predominant influence on overall credit growth.

6.4 Overall, inflationary pressures are expected to be moderate during 2005. Globally and regionally, inflation is forecast to remain low while, domestically, the fiscal *outlook and current monetary policy stance imply a continuance of subdued domestic demand pressures. Real GDP growth is also expected to slow to between 4 percent and 5 percent this year due to slower growth in both the mining and non-mining sectors[9]. In the circumstances, and in the absence of any further substantial rise in administered prices, domestic inflationary pressures can be expected to remain subdued in 2005, and inflation is generally expected to decline during the year.*

7. MONETARY POLICY STANCE IN 2005

7.1 As stated earlier, the annual objective of monetary policy is to achieve a level of inflation that, after taking account of any changes in the nominal Pula exchange rate, will contribute at a minimum to maintaining relative stability in the real exchange rate. The derivation of the inflation objective is anchored on an assessment of the outlook for inflation in trading partner countries. In 2005, the current forecast for these countries is for lower inflation than in 2004. This implies a need for the Bank to lower its objective for 2005 in order to meet its short-term objective of a stable real effective exchange rate.

7.2 It should be recognised that the upward shift of the range to 4 – 7 percent last year was in order to accommodate some of the anticipated increase in inflation arising from the devaluation. It was considered that it would be unrealistic and costly, in terms of output and employment, for the Bank to try and counter the full inflationary fall-out of the devaluation completely over too short a period of time. The Bank nevertheless emphasised that the raising of the upper end of the range should be seen as a short-term tactical measure in response to a specific set of factors in 2004 and that the Bank was still committed to its long-term objective of sustainable low inflation. However, this increase in the upper end of the inflation objective still represented a challenge in the face of cost-related pressures on inflation as it implied that overall inflation would only be allowed to rise by around 1 percent as a result of the devaluation, even though the direct impact on import prices was expected to be significantly more than this amount.

7.3 In the circumstances, although inflation rose in 2004, partly due to the devaluation, it was mostly within the objective range, with the rise towards year-end above the upper end largely attributable to increases in administered prices. In the absence of any further substantial rise in administered prices, and with a stable exchange rate, the Bank anticipates a reduction in both core and headline inflation in 2005. The Bank has concluded, therefore, that an inflation objective of 3 – 6 percent, which at the lower end relates directly to expected trading partner inflation rates, would be appropriate and consistent with the aim of ensuring relative real exchange rate stability in the short-term and contribute to achieving the Bank's longer-term objective of low and stable inflation. The upper end of the objective, though slightly above the higher end forecast for trading partner inflation, is consistent with the desire to bring inflation down on a stable steady path and at a measured pace.

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[9] *Budget Speech, 2005*

7.4 *The Government Budget, announced on February 7, 2005, entails a government expenditure growth rate that is consistent with the inflation objective, which means that fiscal policy will remain supportive of monetary policy. Apart from these policy measures, restraint by parastatals in raising their prices in the current circumstances would help moderate inflationary pressures that arise from administered price increases.*

7.5 *As noted earlier, the Bank's principal intermediate target is the rate of growth of bank credit to the private sector, which is an important contributor to the growth of consumption and investment, and hence to aggregate demand. The Bank explicitly specifies a desired range for credit growth as a guide to setting interest rates at a level needed to achieve the Bank's inflation objective. The range for credit growth that is considered compatible with achieving this year's 3 – 6 percent inflation objective is 10 – 13 percent. The desired credit growth range is derived from the Bank's expectation of the rate of growth of the non-mining sector of the economy (aggregate supply), and the inflation objective for the year, with an allowance for the process of financial deepening as the economy develops.*

8. SUMMARY AND CONCLUSION

8.1 *Inflation maintained an upward trend in 2004 as a result of higher prices following the devaluation of the Pula and increases in administered prices throughout the year, but was within the 4 – 7 percent objective for most of the year. It rose, however, and remained above the upper end of the objective during the fourth quarter following further significant increases in a number of administered prices. Domestic demand pressures nevertheless were subdued, while external influences on domestic prices were also benign.*

8.2 *Global economic growth improved in 2004 following sluggish performance over the previous few years, but is expected to slow moderately in 2005. Global inflation should remain under control, especially if the recent oil price decline persists. There will, therefore, be minimal external pressures on domestic inflation in 2005. Domestically, it is expected that demand pressures will be moderate, with both government expenditure growth and credit expansion generally consistent with the inflation objective. However, there is an upward risk to inflation arising from any further substantial increases in administered prices in 2005, as well as from any adverse movement of the exchange rate impacting on import prices.*

8.3 *Against this background, the challenge for monetary policy in 2005 is to ensure that the anticipated decrease in inflation is realised and contributes toward achieving the Bank's objective of low and sustainable inflation. The Bank will, therefore, conduct monetary policy with the objective of ensuring that inflation falls within the desired range of 3 – 6 percent by the end of the year. To this end, the Bank remains committed to responding appropriately to all economic and financial developments as they relate to keeping inflation in check.*