



Monetary Policy Statement 2019



BANK OF BOTSWANA

STRATEGIC INTENT STATEMENTS

VISION

The Bank aspires to be a world-class central bank with the highest standards of corporate governance and professional excellence.

MISSION

The mission of the Bank is to contribute to the sound economic and financial well-being of the country. The Bank seeks to promote and maintain:

- monetary stability;*
 - safe, sound and stable financial system;*
 - efficient payment mechanism;*
 - public confidence in the national currency;*
 - sound international financial relations;*
- and to provide:*
- efficient banking services to its various clients; and*
 - sound economic and financial advice to Government.*



MONETARY POLICY STATEMENT 2019

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Governor

February 25, 2019

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1. INTRODUCTION

- 1.1 *The Monetary Policy Statement (MPS) is the main medium through which the Bank of Botswana (the Bank) informs stakeholders about the framework for the formulation and implementation of monetary policy. In this regard, the Bank, through the MPS, reviews inflation trends and policy performance and articulates the policy choices for the ensuing year. The Statement also serves to fulfil the public's expectation of a transparent and accountable central bank in implementing the monetary policy mandate as set out in the Bank of Botswana Act (CAP 55:01).*
- 1.2 *The 2019 MPS, therefore, reports on the previous year's economic and policy developments and also evaluates the determinants of changes in the level of prices and their impact on inflation in Botswana. This entails an assessment of economic and financial developments that are likely to influence the inflation path in the medium term and the Bank's policy choices in 2019. Price developments and policy options are evaluated in the context of a forward-looking monetary policy framework, the Bank's medium-term inflation objective range of 3 – 6 percent and the financial stability objective. In this respect, the MPS promotes an understanding of prospective conduct of monetary policy in order to anchor public expectations on the objective of a low, predictable and sustainable level of inflation.*
- 1.3 *Global GDP growth is estimated at 3.7 percent in 2018, lower than an expansion of 3.8 percent in 2017, with mixed performance across countries and regions. Among the advanced economies, there was strengthening of growth in the USA, which was above trend, influenced by fiscal stimulus and stronger consumer demand. In contrast, performance faltered in the euro area, the UK and Japan. This was affected, in the main, by policy uncertainty, adverse impact of rising protectionist sentiments on global trade and constraints to implementation of structural and policy reforms. For the emerging market economies, output expansion remained strong, albeit slowing slightly, in the context of deteriorating financial market sentiment, trade policy uncertainty, weaker external demand and concerns about China's economic outlook.*
- 1.4 *Global inflation rose in 2018, particularly in advanced and emerging market economies, mainly due to the increase in international oil prices.¹ Taking into account the sources of inflation and economic conditions, the European Central Bank and Bank of Japan, maintained their ultra-accommodative monetary policy stance, low policy interest rates and continued to provide liquidity support to the financial sector during 2018. However, policy rates were increased in the USA, towards policy normalisation, and in the UK in order to get inflation back on target. Furthermore, concerns about inflationary second round effects of the oil price increase earlier in 2018 and pass-through from currency depreciation led central banks in several emerging market economies (Chile, Indonesia, Mexico, Philippines, Russia, South Africa and Thailand) to raise policy rates. However, the People's Bank of China (PBoC) maintained the policy rate at 4.35 percent in 2018 and acted to ease domestic funding conditions by lowering primary reserve requirements (PRR) for banks in order to sustain economic activity.*

¹ For advanced economies and emerging market and developing economies, inflation rose to 2 percent and 4.9 percent in 2018, from 1.7 percent and 4.3 percent in 2017, respectively.

- 1.5 *In Botswana, real GDP grew by 5.1 percent in the twelve months to September 2018, compared to a lower expansion of 2.4 percent in the year to September 2017, buoyed by sustained improvement in non-mining GDP growth and the recovery in mining output. Inflation was close to the lower bound of the Bank's medium-term objective range for most of 2018, and was 3.5 percent in December 2018.² Overall, price developments were in the context of subdued domestic demand pressures resulting from the restrained increase in personal incomes and modest foreign inflation.*
- 1.6 *The Bank maintained an accommodative monetary policy stance during 2018 in view of the projected low inflation in the medium-term. The Bank Rate was, therefore, unchanged at 5 percent. The Bank also implemented a downward 0.3 percent annual rate of crawl of the nominal effective exchange rate (NEER) of the Pula, effective January 2018, to moderate the risk of a further appreciation of the real effective exchange rate (REER), which had appreciated slightly in the second half of 2017. Bilaterally, the Pula depreciated by 5.9 percent against the SDR³ during 2018, while appreciating by 7 percent against the South African rand.⁴ The combined effect of weakening of the South African rand and the appreciation of the US dollar contributed to depreciation of the Pula against SDR currencies in 2018; as the rand depreciates against the SDR currencies, the Pula similarly depreciates but proportionate to the weight of the rand in the Pula basket. The REER appreciated by 0.3 percent in December 2018 because of the small positive inflation differential between Botswana and its trading partners that was slightly greater than the depreciation of the NEER.*
- 1.7 *Inflation is forecast to be within the 3 – 6 percent objective range in the medium term. Subdued domestic demand pressures and the modest increase in foreign prices contribute to the positive inflation outlook. This outlook is subject to upside risks emanating from the potential rise in administered prices, commodity prices and government levies and/or taxes beyond the current forecast. However, the potential fall in international commodity prices, modest domestic demand and moderation in global growth, as well as technological progress, productivity improvements and prospective business reforms, present downside risks to the inflation outlook.*

2. MONETARY POLICY FRAMEWORK

- 2.1 *The primary objective of the Bank's monetary policy 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. The policy is also formulated with a view to safeguarding the stability of the financial system. A low and predictable level of inflation and conducive monetary and financial conditions foster savings mobilisation, productive investment and international competitiveness of domestic producers which, in turn, contribute towards the broader national objectives of sustainable economic development and employment creation.*

² *There was a breach of the lower bound of the objective range in March and September 2018 when inflation was 2.8 percent and 2.9 percent, respectively.*

³ *The SDR is the unit of account of the International Monetary Fund (IMF) that comprises the United States dollar, euro, Chinese renminbi (yuan), Japanese yen and British pound. Effective October 1, 2016, the respective weights were 41.73 percent, 30.93 percent, 10.92 percent, 8.33 percent and 8.09 percent.*

⁴ *Pula basket weights for 2018 were 45 percent for the rand and 55 percent for the SDR and have been maintained for 2019.*

2.2 *The monetary policy framework is forecast-based, with a medium-term outlook that primarily guides the Bank's response to projected movements in inflation, while taking into account prospects for economic growth and developments relating to stability of the financial system. To this end, in formulating an appropriate policy stance, the Bank factors in projections of real monetary conditions⁵ in the context of other relevant domestic and international economic and financial developments, and their impact on the output gap⁶ and, ultimately, inflation.*

2.3 *The policy framework recognises the importance of communication in an effort to maintain transparency, predictability and accountability with respect to the policy framework and actions; thus fostering market participation, influencing expectations and policy credibility. In this regard, in addition to the MPS, the Bank publishes the Monetary Policy Report following the April, August and October Monetary Policy Committee (MPC) meetings. Furthermore, the Bank publishes the MPC dates for the year ahead and the Governor delivers a statement at a press briefing subsequent to each meeting of the MPC to allow for engagement with the media and dissemination of the Bank's policy stance.*

3. IMPLEMENTATION OF MONETARY POLICY AND RELATED ECONOMIC DEVELOPMENTS IN 2018

(a) External Developments

3.1 *At the global level, monetary policy implementation varied in response to diverse economic performance and inflation developments across countries and regions. Policymakers continued to focus on the need to achieve sustainable economic growth through facilitating access to finance in a stable environment. Monetary policy was accommodative in advanced economies, with low levels of interest rates and liquidity support to the financial sector. Policy interest rates remained low in Japan and the euro area, while deposit interest rates were negative and asset purchase programmes were maintained in both jurisdictions.*

3.2 *In August 2018, the Bank of England increased the policy interest rate by 25 basis points to 0.75 percent taking into account the strong labour market and rapid credit growth. In the USA, the target range for the federal funds rate was increased four times by a cumulative 100 basis points in 2018 to reach 2.25 – 2.50 percent in December 2018, as the US Federal Reserve (Fed) attempted to prevent a tight job market from causing excessive inflation. In the emerging market economies, monetary policy implementation was also mixed, with policy decisions mainly driven by the need to support economic activity. In South Africa, the repo rate was initially reduced to 6.5 percent (in March),*

⁵ *The real monetary conditions index (RMCI), which reflects the state of real monetary conditions, 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 RMCI combines, through a weighted average, the deviations of the real exchange rate and real interest rate from their respective trend values.*

⁶ *The output gap refers to the difference between actual output and long-term trend output (as an indicator of the productive capacity of the economy). A negative output gap means the actual level of output for a given period is below the trend level for that period, thus indicating that the economy is operating below its estimated potential.*

but later increased to 6.75 percent in November 2018. Meanwhile, in India, interest rates were increased cumulatively by 50 basis points to 6.75 percent, while Brazil eased the policy rate by a cumulative 50 basis points to 6.5 percent. The PBoC maintained its policy rate at 4.35 percent in 2018 and, in September 2018, it reduced the PRR from 15.5 percent to 14.5 percent to boost liquidity in the banking system. In addition, the PBoC also took a decision to launch targeted medium-term lending facilities in December 2018, after the US Fed unveiled a forth hike for 2018.

- 3.3 GDP growth in advanced countries was subdued in 2018. However, output in the USA increased by 2.9 percent in 2018 compared to a 2.2 percent expansion in 2017, supported by the fiscal stimulus, buoyant consumer and business spending, improved financial conditions and stronger global demand. For the euro area, the growth estimate for 2018 was 1.8 percent relative to 2.4 percent in 2017. This was due to, amongst others, subdued domestic demand and higher sovereign borrowing costs and a decline in industrial production.⁷ In Japan, floods and earthquakes during 2018 weighed down on personal consumption and capital investment, thereby contributing significantly to the decline in the rate of growth in output from 1.7 percent in 2017 to 0.9 percent in 2018. Output expansion in the emerging market economies was relatively strong at 4.6 percent in 2018, a slight decrease from 4.7 percent in 2017. The downward influence emanated from the slowdown in the rate of growth in the Chinese economy, as a result of trade tensions, internal policy and structural challenges in some of the emerging market economies and related adverse market sentiment. In the circumstances, global GDP growth is estimated at 3.7 percent in 2018, marginally lower than the 3.8 percent in 2017 (Table 3.1).

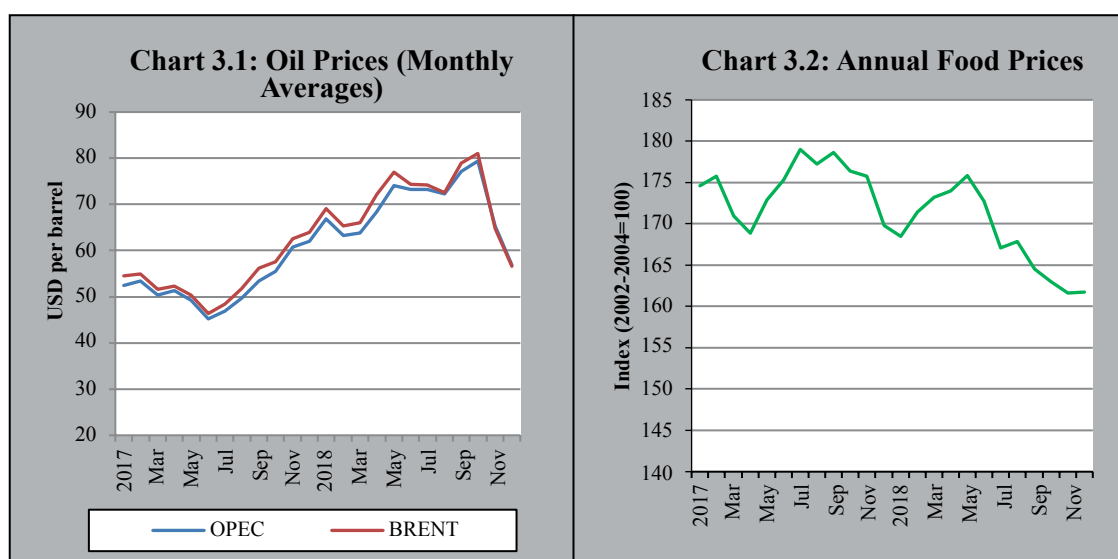
Table 3.1: Real GDP Growth Rates (Percent)

	Estimates		Projections
	2017	2018	2019
World	3.8	3.7	3.5
Advanced economies	2.4	2.3	2.0
United States of America	2.2	2.9	2.5
Euro Area	2.4	1.8	1.6
United Kingdom	1.8	1.4	1.5
Japan	1.9	0.9	1.1
Emerging market and developing economies	4.7	4.6	4.5
China	6.9	6.6	6.2
Brazil	1.1	1.3	2.5
India	6.7	7.3	7.5
Russia	1.5	1.7	1.6
South Africa	1.3	0.8	1.4
Botswana	2.4	4.5	4.2

Source: IMF, January 2019 World Economic Outlook (WEO) Update and Draft 2019 Budget Strategy Paper, Botswana.

⁷ High borrowing costs mainly related to fiscal challenges in Italy while industrial production was affected by the introduction of new fuel emission standards in Germany.

3.4 In 2018, global inflation increased, mainly due to the upward trend in international oil prices. For example, the OPEC crude price increased by 32.4 percent to an average of USD69.50 per barrel in 2018 from an average of USD52.51 per barrel in 2017 (Chart 3.1).⁸ The recovery in oil prices was influenced mainly by prospects of a shortfall in supply arising from sanctions against a major crude oil exporter, Iran. However, oil prices dropped sharply in December 2018, weighed down by rising inventories amid a weak economic outlook and slower increase in consumption. Overall, developments in international oil prices exerted modest upward pressure on domestic inflation in 2018. Meanwhile, international food prices decreased by 3.5 percent in 2018 compared to an increase of 8.1 percent in 2017 (Chart 3.2), driven by a significant fall in sugar prices in 2018, which more than offset the increase in cereal prices.⁹



Source: OPEC and US Energy Information Administration.

Source: Food and Agricultural Organisation.

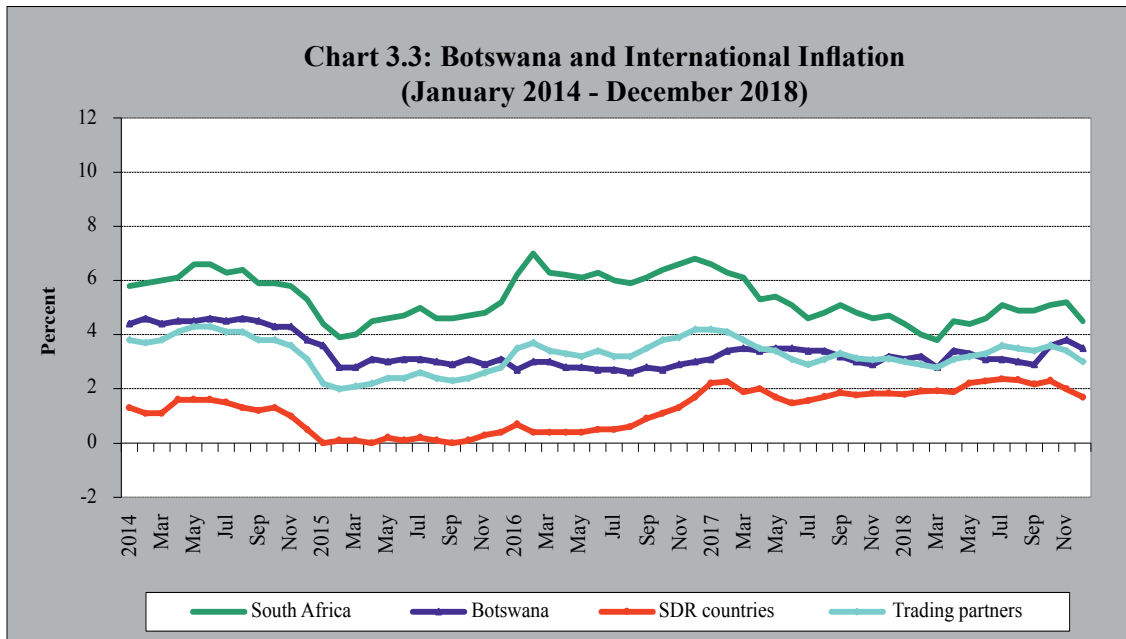
3.5 For Botswana's trading partner countries, trade-weighted average inflation decreased from 3.1 percent in December 2017 to 3 percent in December 2018.¹⁰ Inflation was subdued in the SDR countries, decreasing from an average of 1.8 percent in December 2017 to 1.7 percent in December 2018, and in South Africa,¹¹ inflation eased from 4.7 percent to 4.5 percent in the same period (Chart 3.3).

⁸ Oil prices reached a high of USD81 per barrel in October 2018.

⁹ Sugar prices decreased by 21.9 percent in 2018 compared to a contraction of 11.2 percent in 2017, while the price of cereal increased by 9 percent in 2018 from a rise of 3.2 percent in 2017.

¹⁰ The trade-weighted average inflation comprises South Africa's headline inflation and average SDR countries' inflation.

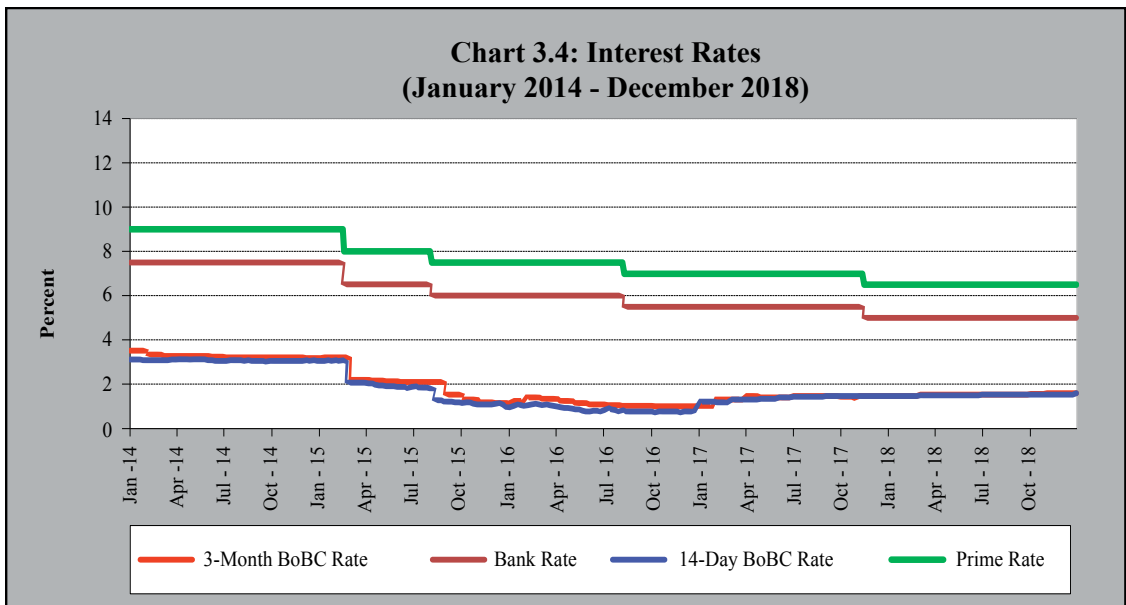
¹¹ Inflation remained within the country's medium-term target range of 3 – 6 percent throughout 2018.



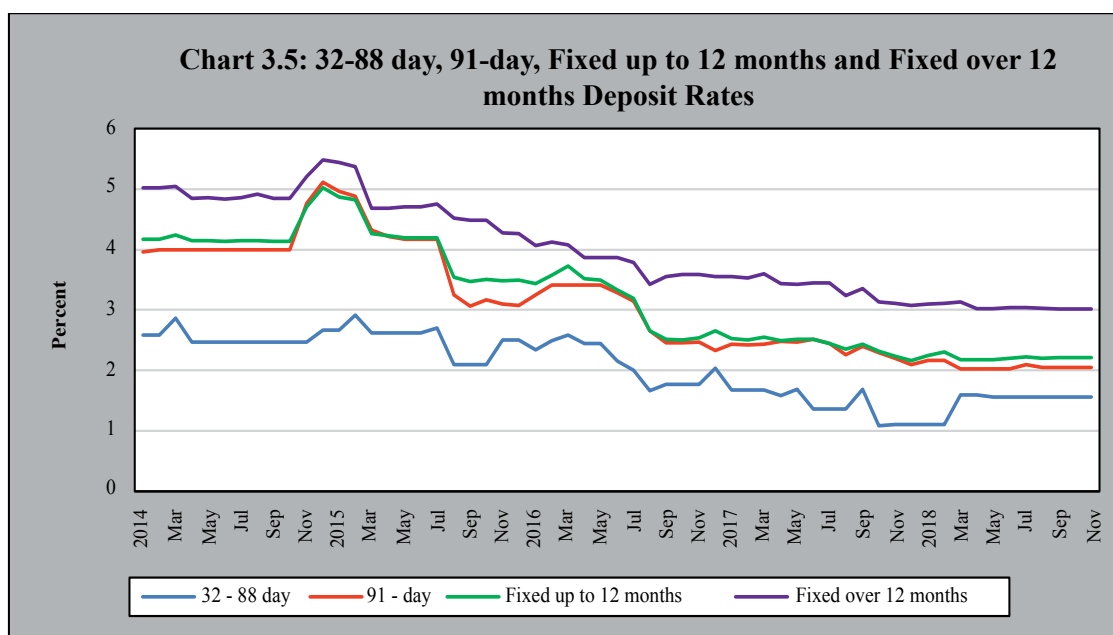
Source: Statistics Botswana and Bloomberg.

(b) Monetary Policy Implementation in Botswana

3.6 Domestically, monetary policy was conducted against the background of below-trend economic activity (a non-inflationary output gap) and a positive medium-term inflation outlook. These developments provided scope for an accommodative monetary policy stance in support of stronger output growth. Hence, the Bank Rate was maintained at 5 percent in 2018, and, consequently, the prime lending rate of commercial banks was unchanged at 6.5 percent, while deposit interest rates were, similarly, virtually stable (Charts 3.4 and 3.5).



Source: Bank of Botswana and commercial banks.

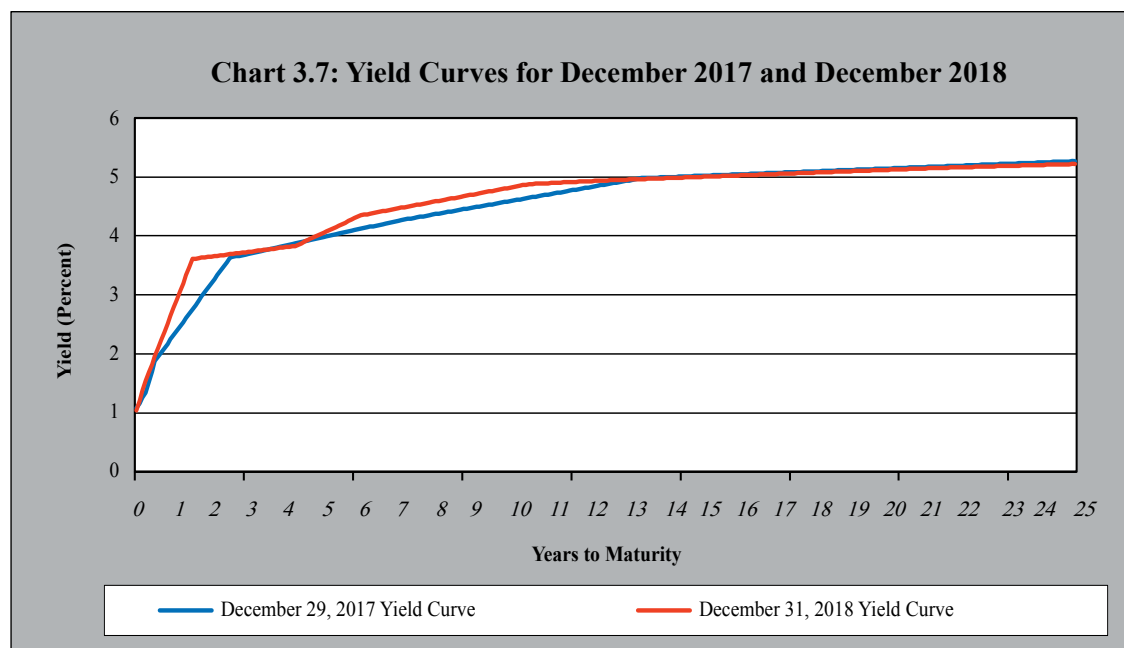
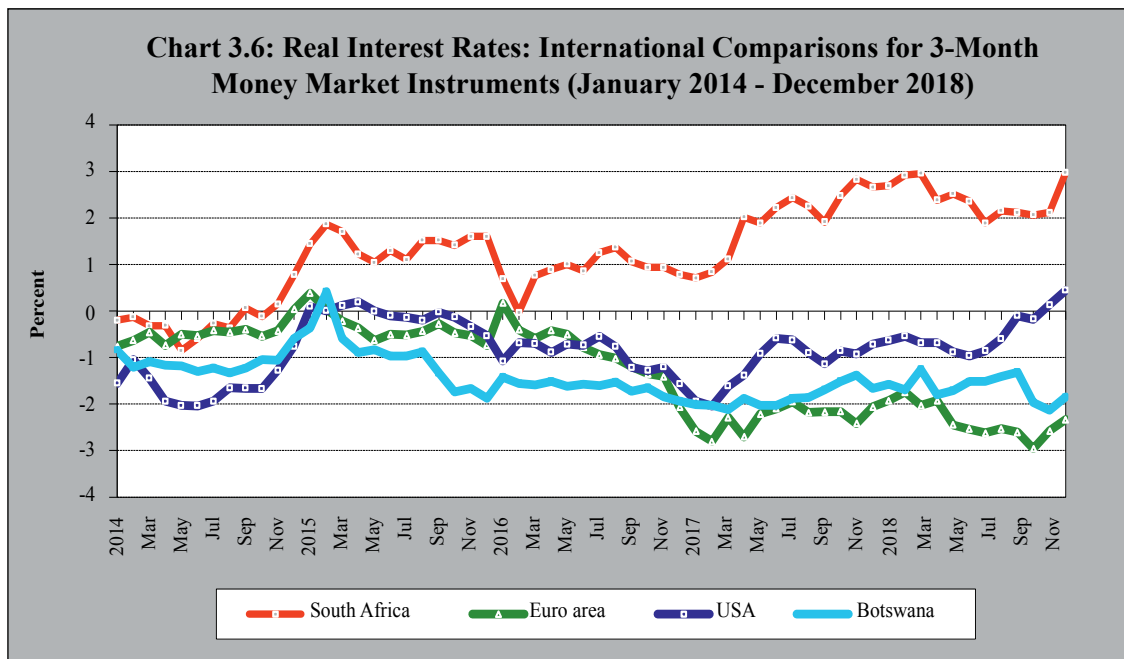


Source: Commercial banks.

- 3.7 Monetary policy implementation entailed the use of Bank of Botswana Certificates (BoBCs) to mop-up excess liquidity¹² in an effort to maintain interest rates that are consistent with the monetary policy stance. The Bank had previously introduced measures, including the lifting of the P5 billion cap on BoBCs in November 2016, to improve market efficiency and effectiveness of monetary operations, in particular to better align market interest rates to the policy stance. In the circumstances, outstanding BoBCs amounted to P8.2 billion in December 2018, an increase from P6.3 billion in December 2017, reflecting an increase in liquidity that had to be mopped-up in the same period to anchor the monetary policy stance.
- 3.8 BoBC yields increased modestly in 2018, reflecting a continuing process of normalisation in money market rates structure. Thus, the 14-day BoBC stop-out yield increased from 1.47 percent in December 2017 to 1.59 percent in December 2018, while the 91-day BoBC stop-out yield also increased, from 1.48 percent to 1.59 percent, during the same period. However, consequent to the larger increase in inflation compared to nominal interest rates between December 2017 and December 2018, the real 14-day BoBC rate decreased from -1.68 percent in December 2017 to -1.85 percent in December 2018, while the real 91-day BoBC yield also decreased from -1.67 percent to -1.85 percent in the same period (Chart 3.6).¹³
- 3.9 Chart 3.7 shows Government bond yields as at end of December 2018 compared to December 2017. Over the review period, yields increased slightly in the mid-section of the yield to maturity curve, as reflected by the slight kink. However, the yields on the longer maturity end of the curve were virtually unchanged.

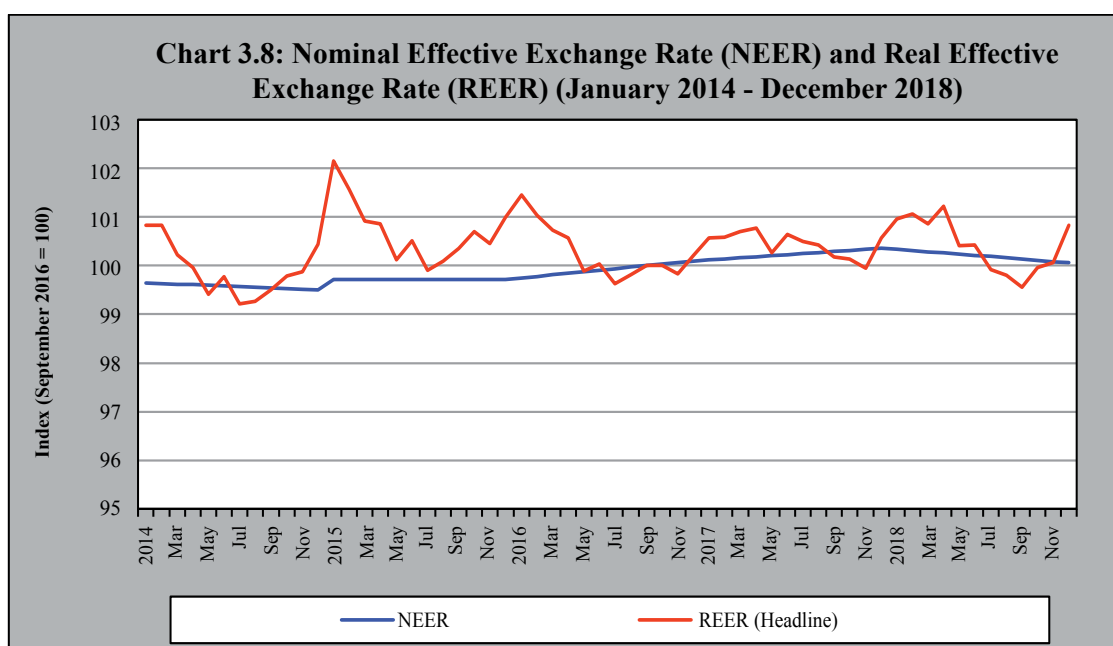
¹² Excess liquidity is the sum of commercial banks' overnight deposits with the Bank (current account), money absorbed through BoBCs and outstanding reverse repos, less both repos and borrowing from the Bank's credit facility. This is "excess" in the sense that it is the net liquidity that the central bank has to absorb (take out of the system), over and above the structural liquidity that is held by the banks in the Primary Reserve Requirement accounts.

¹³ Internationally, the real 3-month money market interest rates were 2.98 percent, 0.45 percent and -2.33 percent in December 2018 for South Africa, USA and the euro area, respectively.



(c) Implementation of Exchange Rate Policy

3.10 The objective of the exchange rate policy is to maintain a stable inflation-adjusted, trade-weighted exchange rate of the Pula, known as the REER. Consequently, a 0.3 percent downward rate of crawl of the NEER was implemented during 2018, with a view to moderate the risk of a further appreciation of the REER, which was evident in the last half of 2017. Consequently, the trade-weighted NEER of the Pula depreciated by 0.3 percent in 2018. The REER appreciated by 0.3 percent in 2018 (Chart 3.8), because of the small positive inflation differential between Botswana and its trading partners that was slightly greater than the depreciation of the NEER.



Source: Bank of Botswana.

(d) Fiscal Policy and Wage Developments

3.11 Monetary policy was conducted within a fiscal policy environment that was supportive of domestic economic activity, with government expenditure expanding by 6.6 percent in the twelve months to December 2018 compared to a contraction of 6.3 percent in the year to December 2017. Recurrent expenditure increased by 9.6 percent, while development expenditure contracted by 3.1 percent in the same period. According to Formal Sector Employment Survey of September 2018, average public sector wages increased by 3.8 percent in the nine months to September 2018.¹⁴ Private sector wages increased by 1 percent in the same period. Overall, nominal national wages increased by 2.3 percent in the nine months to September 2018, marginally lower than the average inflation of 3.2 percent in 2018, suggesting benign inflationary pressures emanating from both fiscal policy and wage growth.

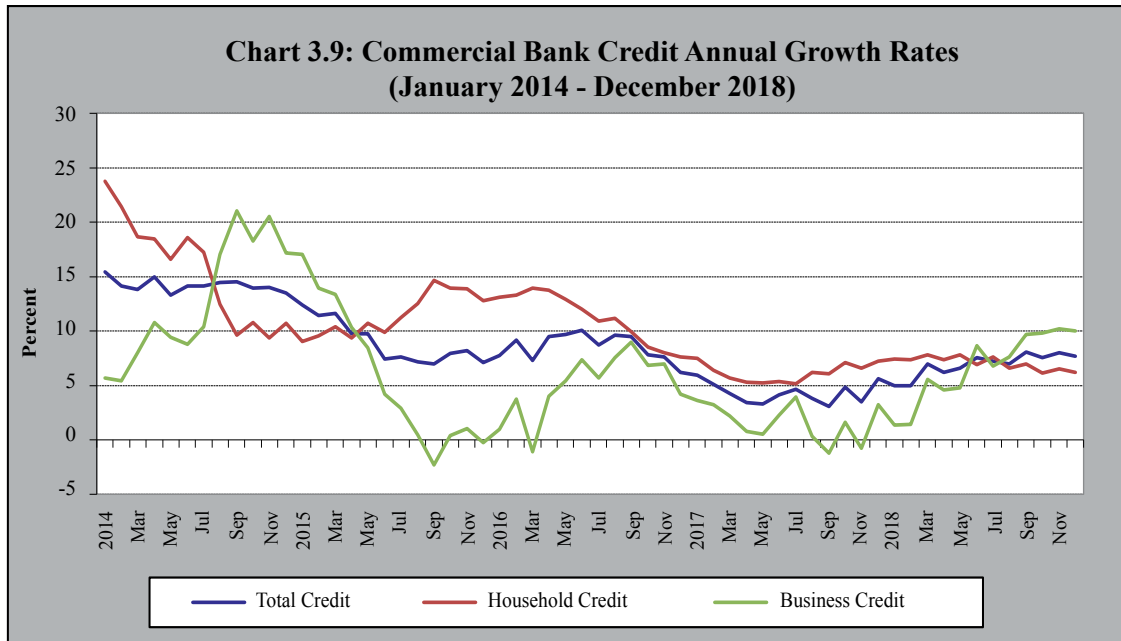
(e) Financial Stability Review

3.12 The domestic financial system remained resilient during 2018, despite some tightening of global financial conditions driven by strengthening of the US dollar, mounting trade tensions as well as, specific to emerging market economies, financial markets pressure emanating from increased borrowing costs, inflation and currency depreciation. Credit growth was moderate and commensurate to the rate of increase in GDP as measured by the Credit to GDP Gap¹⁵. Annual growth in commercial bank credit accelerated from 5.6 percent in 2017 to 7.7 percent in 2018 (Chart 3.9). The annual credit expansion was mostly associated with a faster increase in lending to businesses, from 3.2 percent in 2017 to 10 percent in 2018, with a notable increase in credit with respect to financing of trade, hospitality, tourism, construction and financial services (Chart 3.10). The

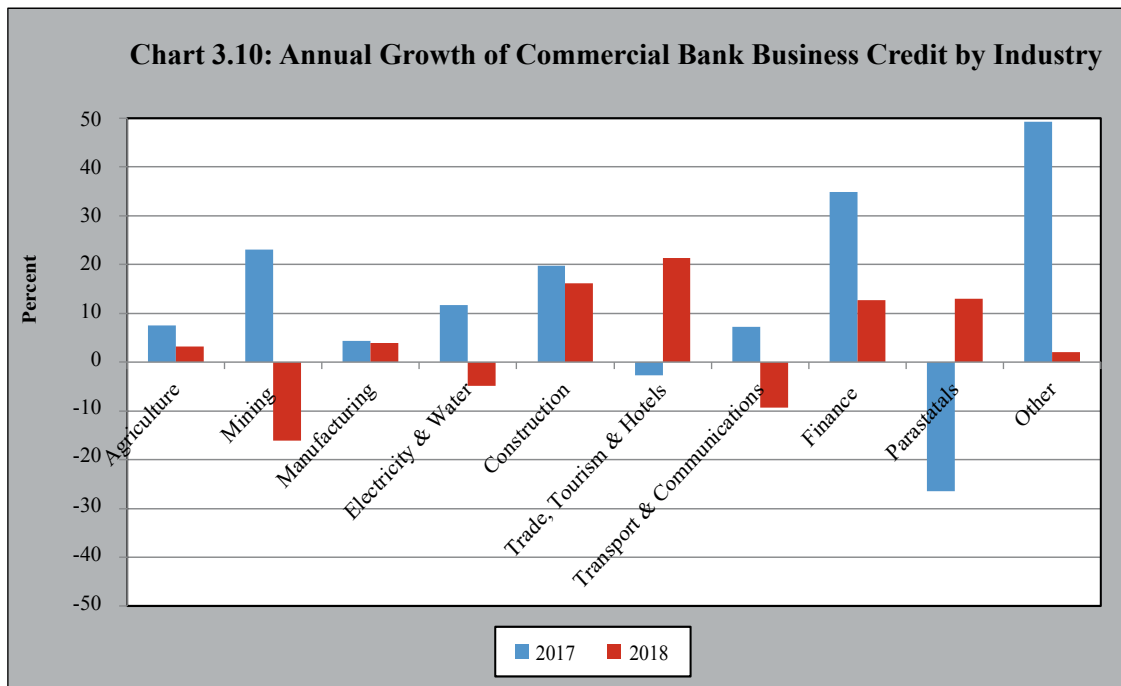
¹⁴ At the time of finalising this report, data for December 2018 was not yet available.

¹⁵ The Credit to GDP Gap (the difference between Credit to GDP ratio and its long-term trend) remains positive and below its long-term trend. The gap is below 10 percent and falling, signalling that there is no elevated risk to financial stability arising from bank crises.

ratio of Business Credit to GDP was 12.3 percent in 2018; thus indicating scope for accommodative monetary policy and disciplined, prudent credit extension to enhance support for sectoral economic activity.



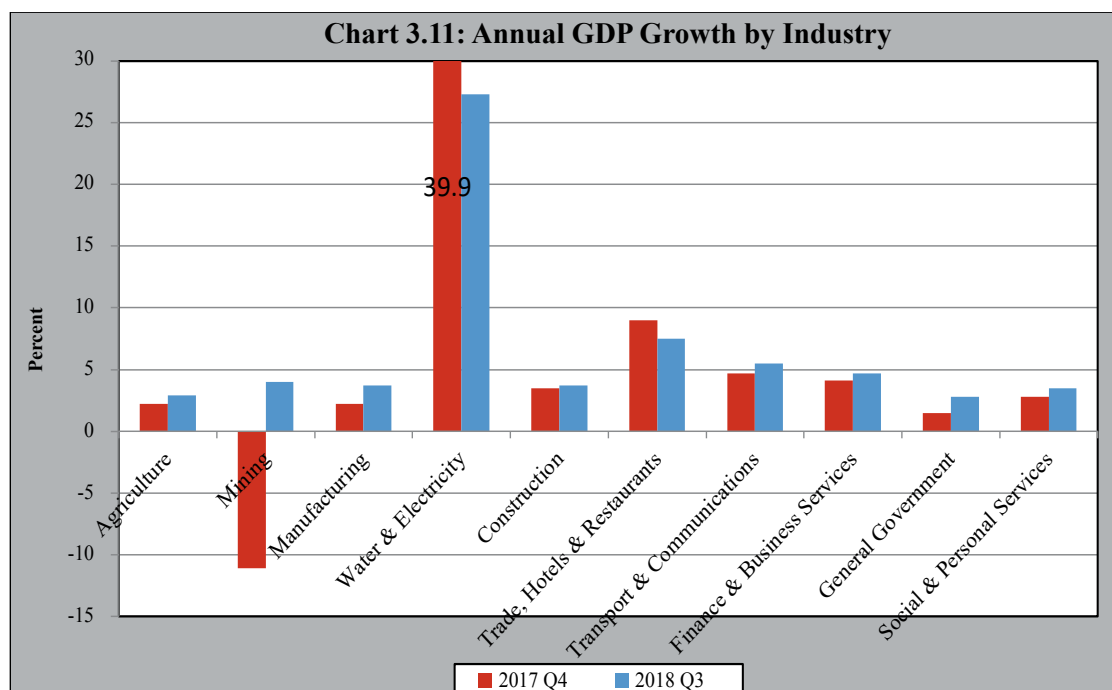
Source: Commercial banks.



Source: Commercial banks.

3.13 For households, annual credit growth decreased slightly, from 7.2 percent in 2017 to 6.2 percent in 2018. The lower rate of increase in lending to households was mostly due to the slower uptake of personal loans, from growth of 9.2 percent in 2017 to 7 percent in 2018. The rate of increase in the unsecured component slowed from 8.8 percent to 6.8 percent in the same period. The share of mortgages in total bank credit to households decreased slightly from 27.8 percent in December 2017 to 27.4 percent in December

2018. Overall, the trend for the Credit-to-GDP ratio remains comparatively low by global standards (Appendix, Table 1) and largely stagnant over time, indicating a need for continuing policy influence and structural shift for the banking sector.



Source: Statistics Botswana and Bank of Botswana calculations.

Note: The growth rate is calculated as the percentage change in cumulative GDP over four quarters compared to the corresponding period ending in the previous year.

Table 3.2: Commercial Bank Credit-to-GDP

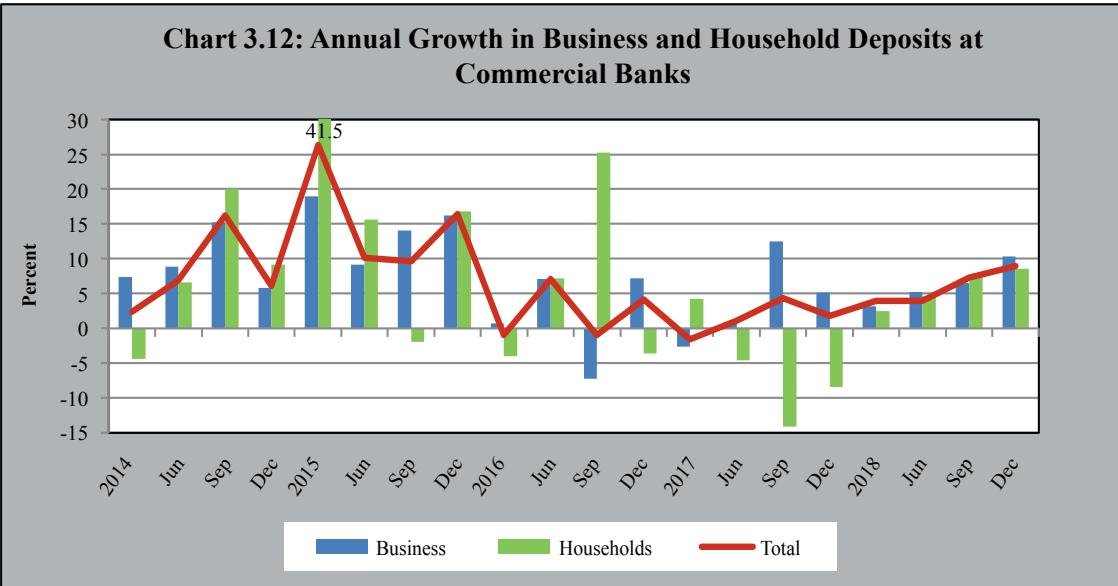
	<i>Percent of GDP</i>		
	<i>2016</i>	<i>2017</i>	<i>2018²</i>
Total Commercial Bank Credit¹	30.1	30.1	30.6
Business	12.0	11.7	12.3
Parastatals	0.8	0.5	0.5
Agriculture	0.7	0.7	0.6
Mining	0.2	0.2	0.1
Manufacturing	1.9	1.9	1.9
Construction	0.5	0.6	0.7
Trade	2.5	2.3	2.8
Transport and Communications	0.4	0.4	0.4
Finance and Business Services	0.8	2.4	2.6
Real Estate	2.2	2.0	2.1
Households	18.1	18.4	18.4
Retail Credit ³	12.9	13.1	13.1
Mortgage	5.1	5.1	5.1

Source: Commercial banks, Statistics Botswana and Bank of Botswana calculations.

- Notes:
1. Although not shown in the table, electricity and water; other and non-resident sub-sectors are included in the business credit to GDP ratio.
 2. Data covering the twelve months to September 2018.
 3. Includes motor vehicle, personal and credit card loans.

3.14 Household credit continued to account for a larger proportion of credit, at 60.2 percent of total bank credit as at December 31, 2018. The level of non-performing loans (NPLs) to total credit remained modest at about 5 percent between December 2017 and December 2018. The ratio of non-performing loans to total loans for households decreased from 4.5 percent in December 2017 to 4.2 percent in December 2018; while for businesses, the NPL ratio decreased to 5.3 percent in December 2018, from 6.2 percent in December 2017. The ratio of Household Debt to GDP has been falling since 2015, and averaged 18 percent in 2018 from 19.6 percent in 2015. In addition, household debt as a proportion of household formal employment income ranged between 46 percent and 50 percent in the period 2016 - 2018. These levels of household indebtedness are considered low by international standards. However, it is observed that household credit is concentrated in unsecured lending (67 percent as at December 31, 2018). A concern would arise in the event of high levels of borrowing that are out of line with trends in economic and personal income growth, which would amplify the risk or exposure of households and businesses to economic shocks and may adversely affect their ability to repay debt. Overall, current levels of credit continued to be supportive of economic activity, while risks are sufficiently mitigated by income, collateral, insurance, diversification, as well as prudential supervision by the Bank.

3.15 Liquidity and funding conditions were supportive of financial intermediation in 2018. Total average market liquidity increased, with total BoBCs rising from P6.3 billion in December 2017 to P8.2 billion in December 2018. The financial intermediation ratio was 84.2 percent in December 2018, slightly above the upper bound of the 50 - 80 percent preferred range. Customer deposits at commercial banks increased by 8.9 percent in 2018, compared to 1.8 percent growth in the prior year (Chart 3.12). The commercial banks' funding structure continues to be dominated by business deposits (70.6 percent of total deposits in December 2018), reflecting an imbalance in the market and the potential increase in funding costs due to the volatile nature of business deposits.¹⁶



Source: Commercial banks.

3.16 Overall, the banking sector continued to be generally safe and sound, adequately capitalised, liquid, profitable (Table 3.3) and fully compliant with the prescribed prudential requirements.

¹⁶ Business deposits tend to attract higher interest rates.

Table 3.3: Selected Performance Indicators of the Banking Sector

	Sep 2017	Dec 2017	Sep 2018	Dec 2018
Capital Adequacy (Percent)				
<i>Core Capital to Total Capital¹</i>	69.2	68.3	67.5	68.0
<i>Core Capital to Risk-Weighted Assets²</i>	12.8	13.3	12.3	13.4
<i>Unimpaired Capital to Risk-Weighted Assets³</i>	18.5	19.4	18.2	19.6
Asset Quality (Percent)				
<i>Non-Performing Loans (NPLs) to Total Loans</i>	5.6	5.3	5.3	5.3
<i>NPLs Net of Specific Provisions to Unimpaired Capital</i>	13.9	12.3	15.6	14.3
<i>Specific Provisions to NPLs</i>	51.7	53.7	47.6	45.2
Liquidity (Percent)				
<i>Liquid Assets to Deposits (Liquidity Ratio)⁴</i>	16.4	17.9	16.5	19.0
<i>Advances to Deposits (Financial Intermediation Ratio)</i>	83.5	85.2	83.8	84.2
Profitability/Efficiency (Percent)				
<i>Return on Average Assets</i>	1.7	0.8	3.9	2.3
<i>Return on Equity</i>	14.5	7.0	33.5	26.5
<i>Cost to Income</i>	60.1	63.9	59.1	60.7

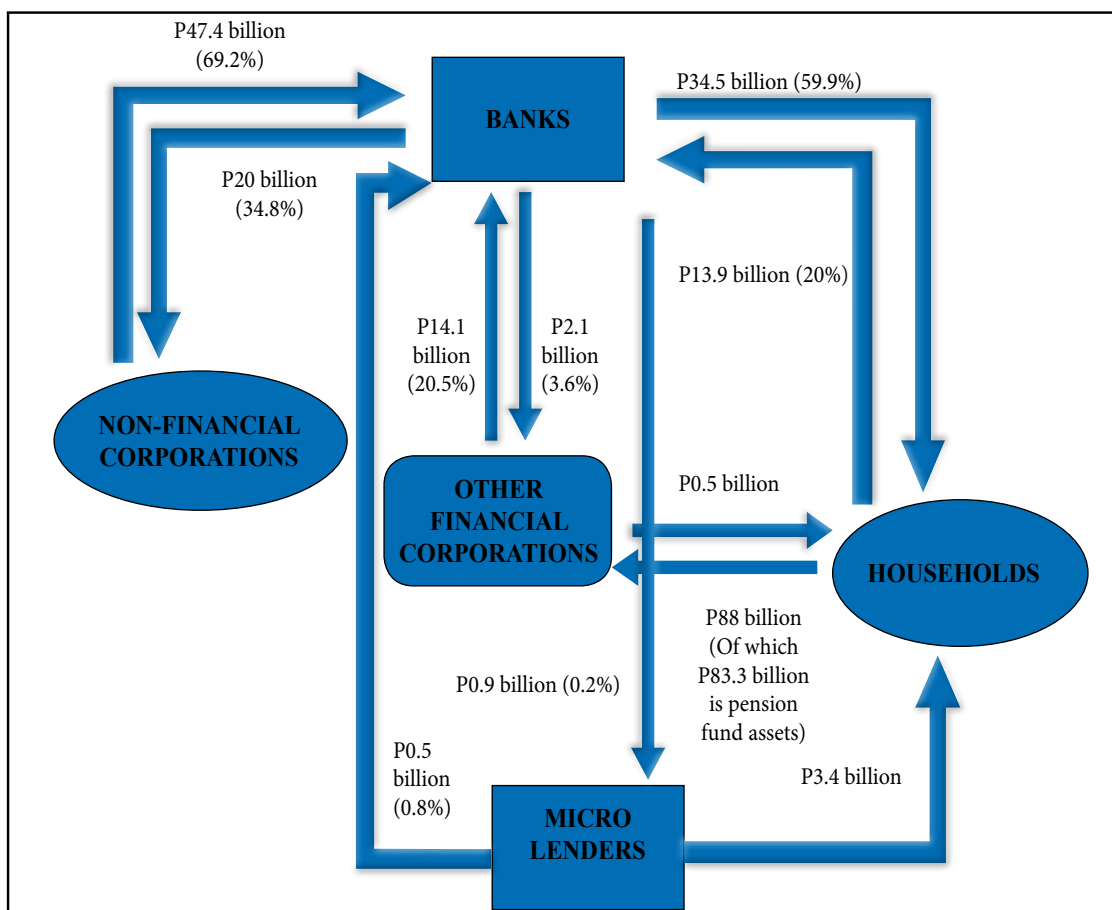
Source: Bank of Botswana.

- Notes: 1. Prudential lower limit is 50 percent.
2. Prudential lower limit is 7.5 percent.
3. Prudential lower limit is 15 percent.
4. Prudential lower limit is 10 percent

3.17 Figure 3.1 shows the interconnectedness of the financial system. Given their intermediation role, banks have many linkages with the rest of the financial system and the real sector. As a result, risks emanating from one sector could adversely affect banks and easily spread to the rest of the financial system (contagion risk). However, the risk of contagion was benign in 2018. Moreover, the relatively modest risk posed by developments in the non-bank financial institutions industry¹⁷, which had the potential to disrupt the financial system, did not materialise.

¹⁷ These include developments in the asset management industry involving allegations of financial impropriety and breaches of corporate governance codes of conduct, as well as the suspension from trading of a major listed company following failure to timeously publish audited financial statements.

Figure 3.1: Structure of the Financial System (September 2018)



Source: Bank of Botswana; estimates based on data provided by financial institutions regulated by Bank of Botswana and Non-Bank Financial Institutions Regulatory Authority.

Note: The percentages indicate shares of loans/deposits for the sector.

3.18 As part of the broader financial development architecture, institutional arrangements for the financial sector oversight are being re-configured to strengthen the macro-prudential dimensions of financial stability policy, oversight and financial safety nets. The Financial Stability Council (FSC) was established in 2018 and this was a significant step towards protecting the viability, integrity and sustainability of relationships and cross-holding of exposures within the financial sector and with other economic sectors. The role of the Council is to promote information exchange, cooperation and coordination in all areas relevant to the stability of the financial system. The Council members comprise leadership of the Ministry of Finance and Economic Development, the Bank, the Non-Bank Financial Institutions Regulatory Authority and the Financial Intelligence Agency.

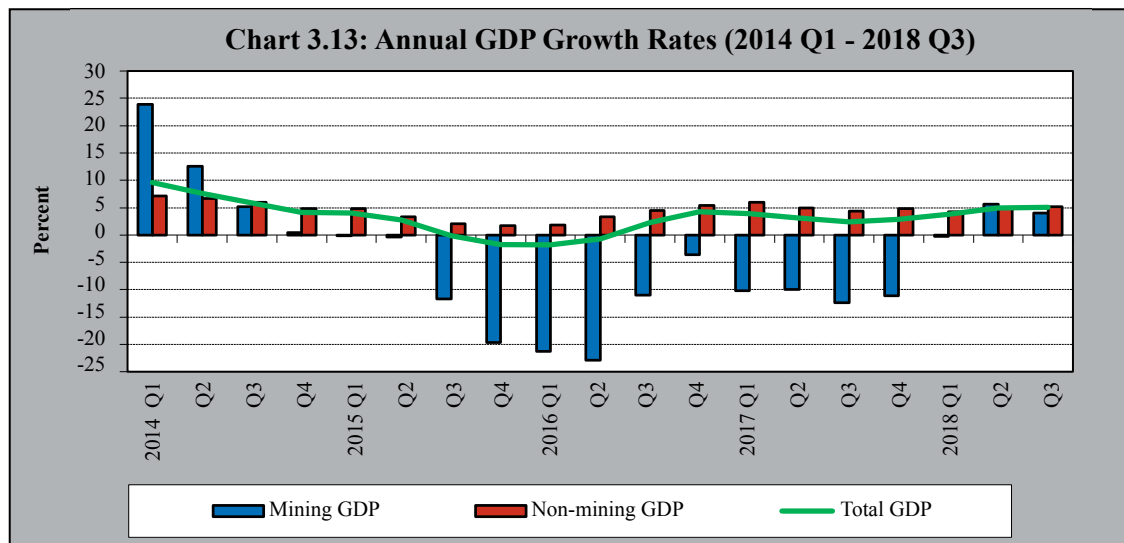
(f) Output and Price Developments

3.19 Real GDP grew by 5.1 percent in the twelve months to September 2018, compared to a lower expansion of 2.4 percent in the year to September 2017, influenced by recovery in mining output and continued improvement in non-mining sectors. Mining output expanded by 4 percent in the year to September 2018, compared to a contraction of 12.4 percent in the corresponding period ending September 2017. The improved performance in mining was driven by the diamond industry and the resumption of production of soda ash at the Botash Mine, following care and maintenance¹⁸ in the second quarter

¹⁸ Source: Statistics Botswana; Gross Domestic Product Second Quarter 2017 Release.

of 2017. Other mining sub-sectors also registered positive growth rates in the period under review, with a notable growth of 109 percent in copper output, albeit from a very low base, mainly reflecting the base effects associated with the closure of BCL mine in October 2016, and resumption of production by smaller mines¹⁹.

3.20 Non-mining GDP grew by 5.2 percent in the twelve months to September 2018, compared to 4.4 percent in the corresponding period ending September 2017. The overall expansion in non-mining GDP was mainly supported by growth of water and electricity (27.3 percent), trade, hotels and restaurants (7.5 percent), transport and communications (5.5 percent) and finance and business services (4.7 percent). Meanwhile, quarterly GDP grew by 4.2 percent between the third quarter of 2018 and the third quarter of 2017.²⁰



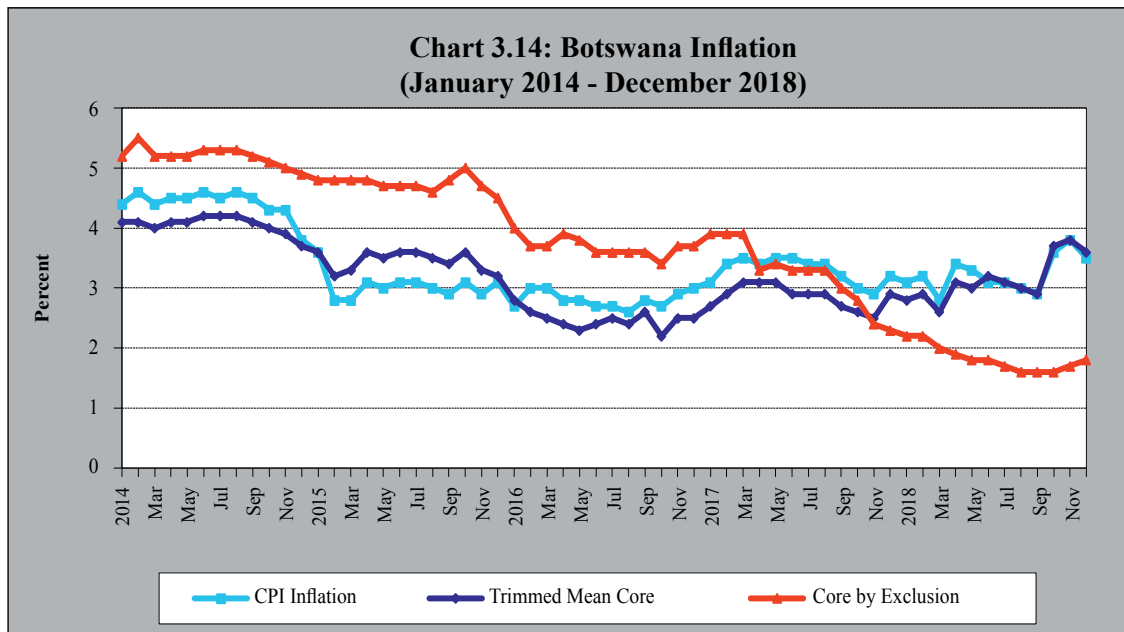
Source: Statistics Botswana and Bank of Botswana calculations.

3.21 Inflation was low and stable in 2018, reflecting, in part, modest domestic demand, the relative strength of the Pula against the rand and the related slower increase in prices of domestic tradeable goods, as well as moderate foreign inflation. The impact of the change in administered prices on inflation was similarly modest, adding 1.6 percentage points to inflation in 2018.

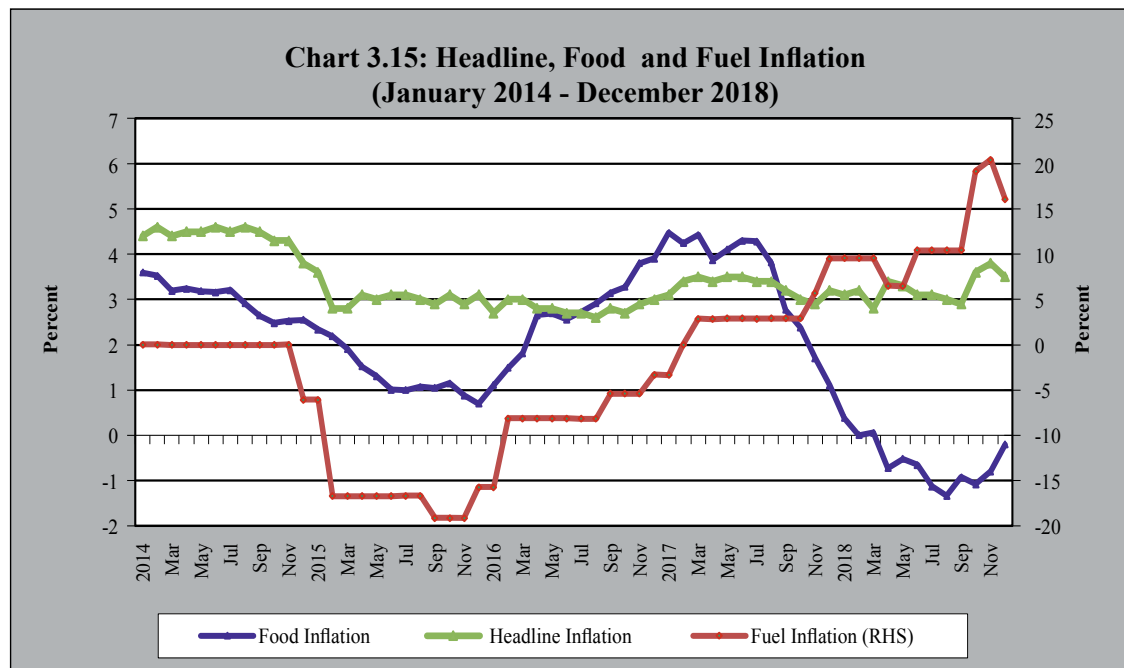
3.22 Inflation increased from 3.2 percent in December 2017 to 3.5 percent in December 2018 and was within the Bank's 3 – 6 percent objective range (Chart 3.14). The rate of increase in prices was modest for most categories of goods and services. However, domestic fuel prices increased significantly by 16.1 percent during 2018, reflecting the upward adjustment of fuel prices in May, October and November 2018, compared to the 9.5 percent increase in 2017. However, food price inflation decreased from 1.1 percent in December 2017 to -0.2 percent in December 2018 (Chart 3.15). Regarding core inflation measures, the 16 percent trimmed mean inflation increased from 2.9 percent in December 2017 to 3.6 percent in December 2018, while inflation excluding administered prices decreased from 2.3 percent to 1.8 percent in the same period; thus indicating the significant influence of administered prices on overall inflation.

¹⁹ These include Mowana mine, which had started producing copper effective April 2017, and later suspended its operations in November 2018, due to lack of capital.

²⁰ The 4.2 percent annual growth reported in the economic briefing release of Statistics Botswana (SB) is calculated on the basis of quarterly output produced in the third quarter of 2018 compared to the level of output produced in the corresponding quarterly period the previous year.



Source: Statistics Botswana.



Source: Statistics Botswana.

4. OUTPUT AND INFLATION OUTLOOK

(a) Global Economic Prospects

4.1 According to the January 2019 World Economic Outlook (WEO) Update, global output is expected to grow by 3.5 percent in 2019, from an estimated expansion of 3.7 percent in 2018. Growth in advanced economies is expected to ease to 2 percent in 2019, from a revised 2.3 percent estimate for 2018, mostly reflecting subdued performance in the euro area, projected to moderate to 1.6 percent in 2019, from 1.8 percent in 2018. USA economic expansion is expected to ease to 2.5 percent in 2019, as the fiscal stimulus unwinds. Meanwhile, the UK economy is forecast to grow by 1.5 percent in 2019, from 1.4 percent in 2018, in the context of the negative effect of the uncertainty around Brexit

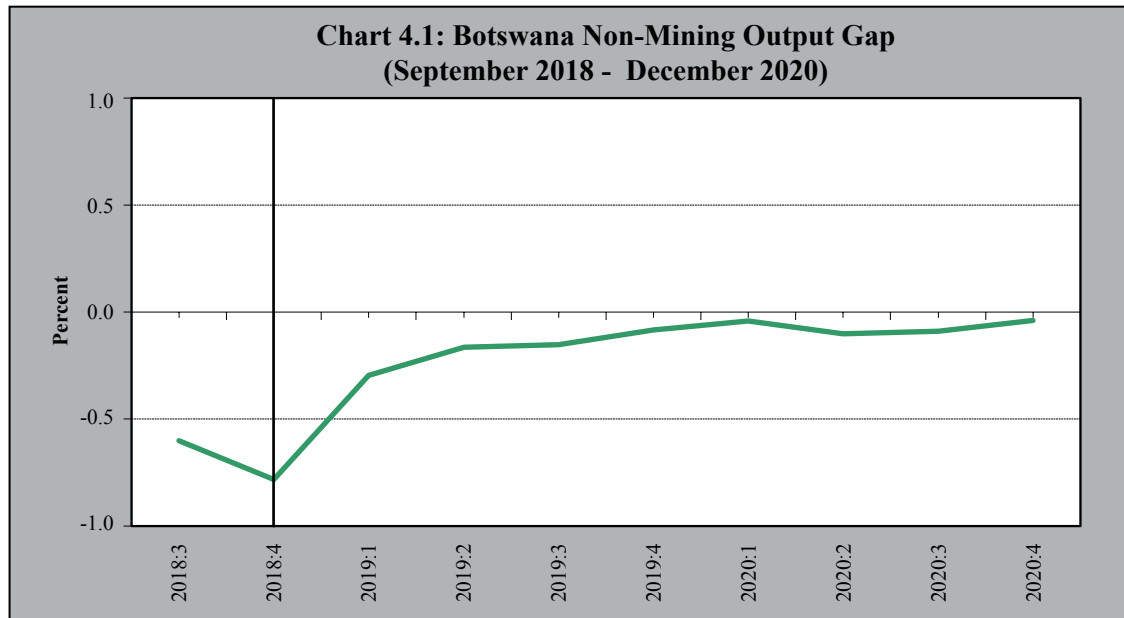
which, however, is offset by the positive impact from fiscal stimulus announced in the 2019 budget.

- 4.2 Growth in emerging market and developing economies is projected at 4.5 percent for 2019, slightly down from the revised 4.6 percent in 2018. The lower growth projection mainly reflects the GDP contraction in Argentina and Turkey. The imposition of trade tariffs on China is also expected to negatively affect economic performance in China and spreading to other Asian economies. Overall, risks to global economic activity are skewed to the downside, with prospects for escalation of trade tensions, tightening financial conditions, a no-deal Brexit and weaker growth in China than currently anticipated presenting key risks to the outlook.
- 4.3 In the circumstances, the January 2019 WEO Update highlights the need for policymakers, globally, to prioritise cooperation and quick resolution of trade disagreements and the resulting policy uncertainty, rather than raising harmful barriers further and destabilising an already slowing global economy. Moreover, it is considered that measures to boost potential output growth, enhance inclusiveness, and strengthen fiscal and financial buffers in an environment of high debt burden and tighter financial conditions are critical across all economies.
- 4.4 Global inflationary pressures are forecast to be modest in the short to medium term, reflecting below-potential output. There is upward pressure on inflation emanating from the increase in commodity prices, particularly oil, strengthening labour markets, as well as the expansionary monetary and fiscal policies. Overall, global inflation is forecast at 3.8 percent in 2019. Given modest inflation and below-potential output, it is anticipated that monetary policy will remain accommodative in most economies, complemented by measures aimed at facilitating financial intermediation, while fostering resilience of the financial sector, to support economic activity.
- 4.5 Inflation is forecast at 1.8 percent and 4.8 percent in the SDR countries and South Africa, respectively, in 2019. Thus, average inflation for trading partner countries is forecast to be in the range of 3 – 4 percent. Consistent with the policy objective of maintaining a stable REER of the Pula, an annual upward rate of crawl of the NEER of 0.3 percent is being implemented effective January 2019, as domestic inflation is projected at around the lower end of the Bank's inflation objective range and slightly lower than the trading partner countries' forecast average inflation. The Pula basket weights have been maintained at 45 percent for the South African rand and 55 percent for the SDR. Against this background, it is anticipated that the impact of external price developments on domestic inflation, through imported inflation and changes in the exchange rate, will be modest.

(b) Domestic Economic Prospects

- 4.6 As indicated in the 2019 Budget Speech, domestic output growth is forecast to be 4.2 percent in 2019, lower than the estimate of 4.5 percent for 2018, with non-mining output expected to remain below trend in the short to medium term (Chart 4.1). The significant influences on domestic economic performance include conducive financing conditions as indicated by accommodative monetary policy and sound financial environment, facilitating policy transmission, intermediation and risk mitigation. Moreover, it is anticipated that an increase in government spending, as well as implementation of

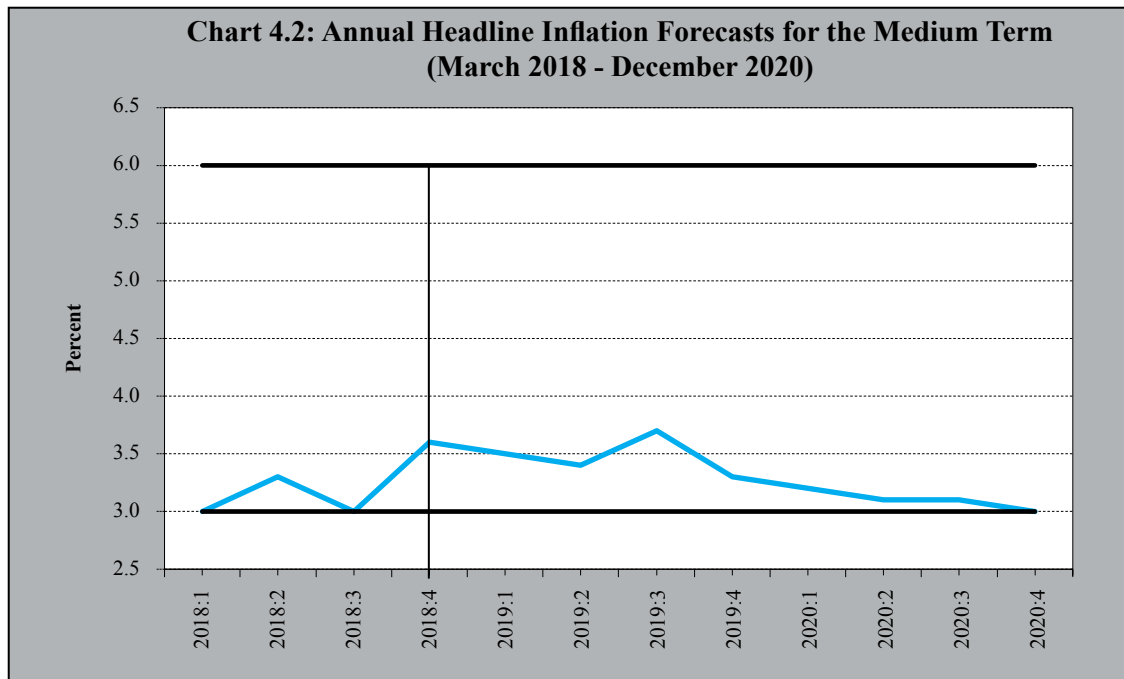
initiatives such as the doing business reforms should also be supportive of economic activity. Furthermore, while global economic growth is forecast to weaken, it is anticipated that the specific markets for key exports for Botswana will remain buoyant. Against this background, the Bank's September 2018 Business Expectations Survey (BES) indicates an improvement in the level of confidence among businesses in 2019, and is premised on the expected increase in demand for consumer products and the sustained global demand for diamonds.



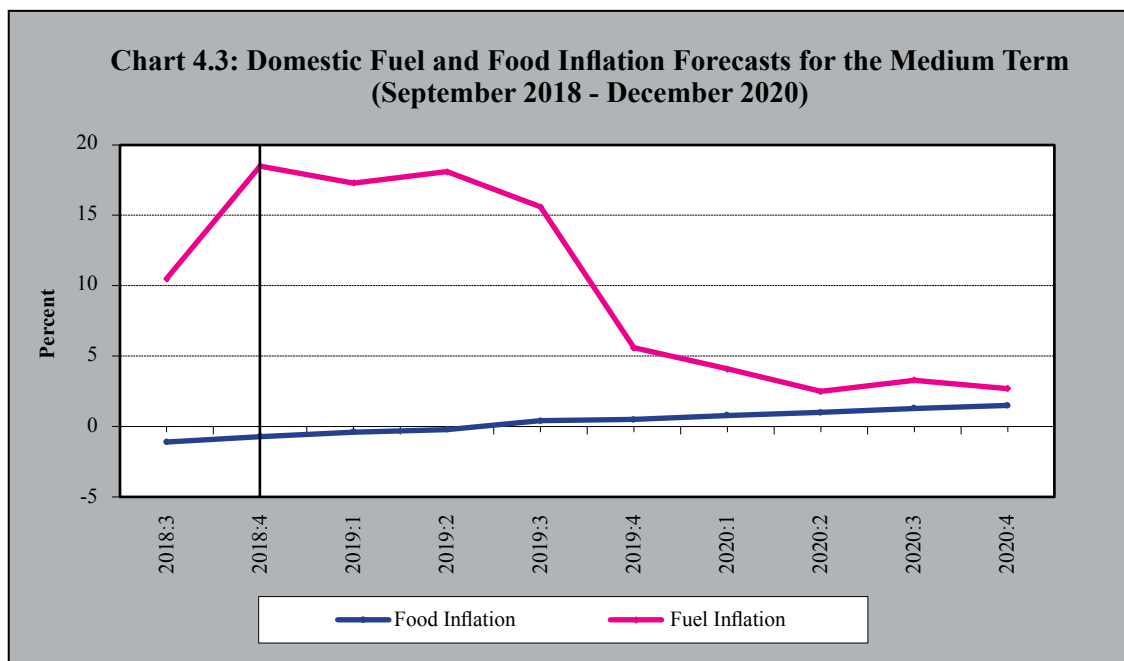
Source: Statistics Botswana.

- 4.7 Regarding potential fiscal impact, total government expenditure is budgeted to increase by 3.6 percent in the 2019/20 fiscal year, while revenue and grants are projected to increase by 3.4 percent, resulting in a budget deficit of P7.3 billion (3.5 percent of GDP). To finance the budget deficit, Government will borrow both domestically and externally. Domestic borrowing will entail issuance of Government debt securities, such as Treasury Bills and long-term Government bonds, while external borrowing will be restricted to concessional borrowing from both bilateral and multilateral development partners. It is noted that government spending is more effective in supporting demand in cases where expenditure is mainly in the areas that generate a large multiplier effect, such as infrastructure development²¹, improvements in human capital and inputs to production generally, as well as local procurement.
- 4.8 Headline inflation is projected to be within the 3 – 6 percent objective range in the medium term, but slightly above the lower bound of the objective range (Chart 4.2). The higher short-term inflation projection reflects the impact of the recent increase in domestic fuel prices, hence higher fuel inflation (Chart 4.3), and private school fees in the fourth quarter of 2018 and first quarter of 2019, respectively. The projection also takes into account the anticipated upward adjustment in public sector salaries in the second quarter of 2019. However, there are base effects associated with the increase in administered prices in the second quarter of 2018, which contribute to the decline in inflation in the second quarter of 2019.

²¹ It is recognised, nevertheless, that there are leakages in the short-term because of the high import content of infrastructure development.



Source: Statistics Botswana.



Source: Statistics Botswana.

4.9 *Prospects for benign foreign inflation and a broadly stable Pula exchange rate also contribute to the positive domestic inflation outlook in the short-to-medium term. It is anticipated that domestic demand pressures on inflation will continue to be modest in the medium term, owing to the moderate economic activity. In addition, the restrained global economic activity, the tendency of the ongoing technological progress to lower costs and prices and reduction in commodity prices could suppress inflation.*

4.10 *Upside risks to the inflation outlook relate to any unanticipated substantial upward adjustment in administered prices and government levies and/or taxes. Externally, any increase in international commodity prices beyond current forecasts may exert upward*

pressure on domestic inflation. Meanwhile, as indicated in the September 2018 BES, businesses expect inflation to be close to the lower end (3.6 percent) of the Bank's medium-term inflation objective range in 2019.

5. 2019 MONETARY POLICY STANCE

- 5.1 An evaluation of the determinants of inflation and financial stability suggests continuation of low and predictable level of inflation into the medium term, and stable financial system. The current levels of growth in credit to both businesses and households are considered to be sustainable. Thus, the recent and prospective developments (positive inflation outlook and a stable financial environment) augur well for maintaining an accommodative monetary policy that supports productive lending to businesses and households. The Bank will continue to respond appropriately to changes in banking system liquidity conditions through relevant instruments. Overall, the Bank encourages prudent management, investment and productive allocation of financial resources, with a view to promoting growth-supporting intermediation and durable financial stability. In this regard, for effective policy transmission, the Bank guides the determination of the level and direction of market interest rates that are consistent with the monetary policy stance. The Bank also promotes the effectiveness of the interbank market to address liquidity positions of individual banks. In addition, the Bank contributes to financial stability through prudential supervision of commercial banks and statutory banks and promotes, as well as participates in, coordinated regulation of the broader financial system.*
- 5.2 The Bank evaluates its monetary policy implementation framework on a regular basis for effectiveness, with a view to introducing refinements where necessary. In this respect, in early 2019, the Bank will implement “Reserves Averaging” for the Primary Reserve Requirement (PRR) and shorten the maturity of the 14-day BoBC to seven days. Under Reserves Averaging, the commercial banks do not have to meet the PRR daily but, rather, fulfil this requirement on an average basis over the maintenance period.²² Reserves Averaging, which is widely used in other jurisdictions, both globally and in the region, has been shown to improve liquidity management by commercial banks, encouraging resource allocation through the interbank market and reducing the demand for excess reserves held for precautionary purposes so as not to violate the PRR. The reduction of the BoBC maturity from 14 days to seven days will provide the Bank and commercial banks with a shorter and simpler forecasting horizon for liquidity management. As such, this will provide a solid basis for the starting point of the monetary policy transmission mechanism, supporting the extension of the signal along the yield curve. Consultations with the commercial banks regarding the implementation of these measures will commence shortly, with a view to their introduction as soon as possible.*
- 5.3 The Bank will continue to implement measures to ensure better structural alignment of short-term market rates and desirable policy transmission by lifting any notional ceiling on the issuance of BoBCs. This is expected to allow for greater scope and flexibility for effective liquidity absorption by the central bank in response to market developments, unconstrained by any undue impediment. In addition, during the coming months, the Bank will undertake a process of consultation with the market on further possible changes to monetary operations and the “anchor policy rate”. This will be with the objective*

²²

For the case of Botswana, the maintenance period will continue to be the calendar month.

of strengthening transmission of monetary policy in terms of the signal provided by the announcement of the policy rate and influence on subsequent market reaction and posture. Moreover, there is need to balance the objective of limiting volatility in money market rates with the desire to encourage the development of functioning money markets. The modalities of the consultation will be announced shortly and it is envisaged that the exercise will be completed by the middle of the year.

- 5.4 *In 2019, the Bank's implementation of the exchange rate policy will entail a 0.3 percent annual upward rate of crawl of the NEER to stabilise the REER. The crawling band exchange rate policy supports international competitiveness of domestic industries and contributes towards macroeconomic stability and economic diversification. Notionally, relatively high interest rates in South Africa would induce related capital outflows. However, short-term capital movements are constrained by the paucity of listed securities (bonds and equities), relative illiquidity of financial markets in Botswana, as well as uncertainty associated with a volatile rand exchange rate and higher South African inflation. Moreover, on its own, Botswana represents a stable macroeconomic environment with developmental and business opportunities for inward investment by expanding regional entities.*

6. CONCLUSION

- 6.1 *Domestic inflation was mostly within, and close to the lower end of the Bank's objective range of 3 – 6 percent in 2018, against the background of modest wage growth and the resultant benign domestic demand pressures, as well as favourable foreign price developments. Meanwhile, global inflation is forecast to increase slightly due to the anticipated modest rise in international oil prices.*
- 6.2 *It is projected that inflation in Botswana will remain low and stable in the medium term, consistent with the Bank's objective range. The Bank's formulation and implementation of monetary policy will focus on entrenching expectations of low and sustainable inflation, through timely response to price developments, while ensuring that credit and other market developments are in line with durable stability of the financial system. The Bank remains committed to monitoring economic and financial developments with a view to ensuring price and financial stability, without undermining sustainable economic growth.*

Appendix

Table 1: Credit to Private Sector by Banks (Percent of GDP)

	2015	2016	2017
<i>United States of America</i>	51.6	53.0	...
<i>United Kingdom</i>	132.7	134.1	135.9
<i>India</i>	51.9	49.5	...
<i>China</i>	152.5	156.8	155.8
<i>Singapore</i>	124.0	127.4	128.2
<i>Chile</i>	80.6	79.8	78.6
<i>Rwanda</i>	20.9	20.8	20.7
<i>Mauritius</i>	102.7	96.2	101.7
<i>Namibia</i>	52.5	51.4	51.0
<i>Kenya</i>	34.1	32.6	30.9
<i>South Africa</i>	68.2	66.7	65.6
Botswana	33.7	31.5	31.4

Source: World Bank's World Development Indicators.

- Notes: 1. Domestic credit to the private sector by banks refers to financial resources provided to the private sector by other depository corporations (deposit taking corporations except central banks), such as through loans, purchases of non-equity securities, and trade credits and other accounts receivable, that establish a claim for repayment. For some countries, these claims include credit to public enterprises.
2. ... represents unavailable data (Note that data for 2018 is also not available).

MONETARY POLICY COMMITTEE MEETING DATES FOR 2019

<i>Date</i>		<i>Time</i>	<i>Venue</i>
<i>February</i>	<i>26</i>	<i>0830 hours</i>	<i>Bank of Botswana</i>
<i>April</i>	<i>24</i>	<i>0830 hours</i>	<i>Bank of Botswana</i>
<i>June</i>	<i>27</i>	<i>0830 hours</i>	<i>Bank of Botswana</i>
<i>August</i>	<i>29</i>	<i>0830 hours</i>	<i>Bank of Botswana</i>
<i>October</i>	<i>31</i>	<i>0830 hours</i>	<i>Bank of Botswana</i>
<i>December</i>	<i>5</i>	<i>0830 hours</i>	<i>Bank of Botswana</i>

