

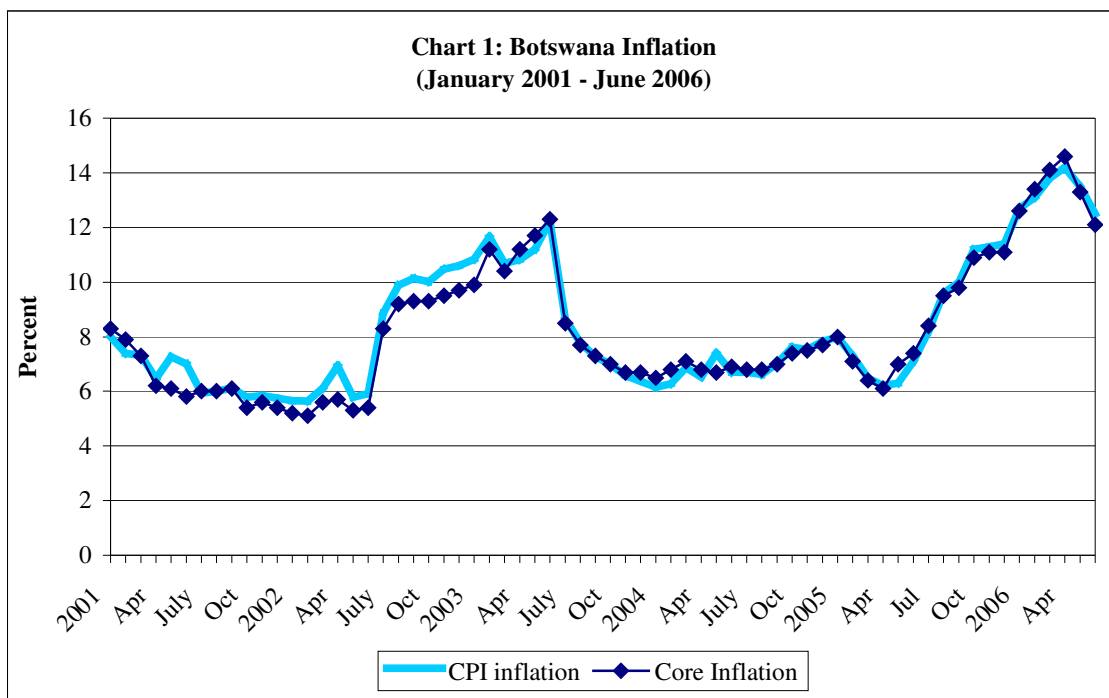
MID-TERM REVIEW OF MONETARY POLICY STATEMENT 2006

1. Introduction

- 1.1 *There are three objectives to undertake a mid-term review of the Monetary Policy Statement (MPS). First, it is intended to review progress in attaining the objectives of monetary policy outlined in February 2006; second, it evaluates the financial and economic outlook for the remainder of the year, and assesses the need to review the current monetary policy stance; and third, it informs stakeholders of the key issues that are likely to influence policy formulation in the remainder of the year, in order to affect the formation of expectations, particularly with respect to inflation.*
- 1.2 *At the beginning of the year, the Bank set an annual inflation objective of 4 – 7 percent for 2006 in consideration of, among others, inflation in trading partner countries, which was forecast to be unchanged from that of 2005. While this suggested a need to lower the inflation objective in order to meet the related objective of a stable real effective exchange rate (REER), the outlook was that domestic inflation would remain significantly higher than inflation in trading partner countries, mostly reflecting the sustained impact of the May 2005 devaluation and the increase in administered prices. Although the Bank would actively formulate monetary policy to achieve low inflation, it was considered appropriate to accommodate some of the transitory additional inflation in the short-term. Moreover, the crawling band exchange rate arrangement would complement monetary policy towards achieving stability of the REER. In the circumstances, the Bank also announced a medium-term (3 - year period to 2008) inflation objective for the first time, thus recognising that policy decisions take time to impact on intermediate targets and inflation. This is particularly relevant in the context of continuing efforts to increase productivity and a trend towards achieving more efficient pricing for parastatal and government services.*
- 1.3 *In controlling inflation, the Bank influences changes in aggregate domestic demand, with a primary focus on the intermediate target, the growth rate of commercial bank credit, given that it contributes significantly to domestic demand pressures and can be influenced by monetary policy. Moreover, while the Bank has no direct influence on fiscal policy, it monitors the annual change in government spending, as it is a major component of consumption and investment expenditure. To this end, the Bank focuses on the growth of government spending that is non-inflationary and consistent with its inflation objective. Monetary policy also responds to and seeks to influence the formation of public expectations with respect to inflation, particularly in the context of discrete and transitory shocks such as an increase in administered prices. The Bank, therefore, remains committed to responding appropriately to any inflationary effects of fiscal measures and expectations.*

2. Inflation in the first half of 2006

2.1 Inflation generally rose in the first half of 2006, from 11.4 percent in December to 14.2 percent in April, before falling to 12.5 percent in June 2006 (Chart 1), as the impact of the May 2005 devaluation began to drop out of the inflation calculation¹. The rise in inflation was attributable to the increase in administered prices, including the re-introduction of fees in government secondary schools, which contributed 1.1 percentage points (revised from the original 4.3 percentage points) and fuel prices, which were increased three times in the first half of the year in response to high international oil prices; the latter contributed around 1 percentage point to inflation between January and June 2006. Core inflation² also increased from 11.1 percent at the end of 2005 to 12.1 percent in June 2006.



2.2 By tradeability, the annual increase in the cost of all-tradeables rose from 13.6 percent in December 2005 to peak at 16 percent in April, largely reflecting, among others, the impact of fuel and vehicle price increases, as well as the effect on retail prices of the 40 percent increase in producer prices of cattle by the Botswana Meat Commission. The year-on-year increase in the cost of tradeables fell to 14 percent in June 2006 as the impact of the May 2005 devaluation began

¹ The Central Statistics Office had initially reported inflation of 16.6, percent, 17 percent and 17.7 percent for January, February and March, respectively. These figures were subsequently revised to 12.7 percent, 13.1 percent and 13.8 percent after a review of the estimated impact of the re-introduction of school fees in government secondary schools.

² The Bank uses the trimmed mean approach to measure core inflation. This approach removes the most extreme price changes, regardless of their source and direction.

to drop out of the inflation calculation.³ For non-tradeables, the yearly increase in cost initially rose from 6 percent in December 2005 to 10.3 percent in April 2006, mainly reflecting the impact of the rise in the cost of education (following the re-introduction of fees in government secondary schools) and health and personal care, before declining to 9 percent in June.

3. Influence on Inflation in the first half of 2006

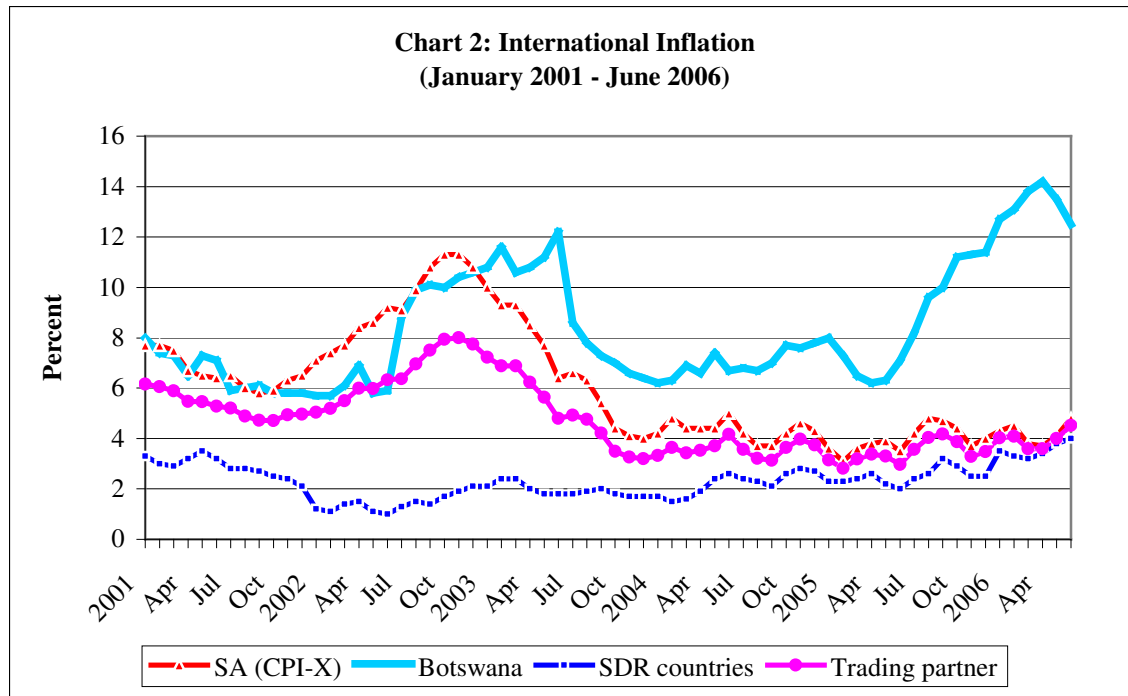
3.1 World economic performance improved in the first half of 2006, with annual output growth of just under 4 percent. Global output expansion is mainly underpinned by the increase in global trade growth due to strengthening demand in the USA, China and the euro area and an increasingly efficient supply of goods by the emerging Asian economies. Despite robust growth and the high international oil prices (resulting from geopolitical tensions and supply constraints), global inflation is restrained in 2006 at just under 3 percent, the same level as that of 2005.

3.2 Average inflation for Botswana's trading partner countries⁴ rose moderately in the first half of 2006, from 3.5 percent in December 2005 to 4.5 percent in June 2006 (Chart 2), mostly reflecting the impact of the rise in international oil prices. South African CPIX inflation⁵ rose from 4 percent at the end of 2005 to 4.8 percent in June 2006, while average inflation for the SDR countries increased from 2.5 percent in December 2005 to 4 percent in June 2006. In addition to productivity improvements and increased competition in the goods market, inflationary pressures were restrained by policy tightening in some of the major economies and increasingly successful management of inflation expectations. Notably, the USA raised interest rates four times in the first half of the year, while in the euro area the refinancing rate was increased three times beginning in December 2005 (the first upward adjustment of interest rates in 5 years). The South African Reserve Bank also tightened monetary policy in June 2006, for the first time in 14 months.

³ The deceleration in the tradeables inflation reflects the decrease in the rate of annual price increase for vehicles to 8.8 percent, as the impact of the 24.1 percent vehicle price increase of May 2005 dropped off the calculation of the annual change in the cost of vehicles.

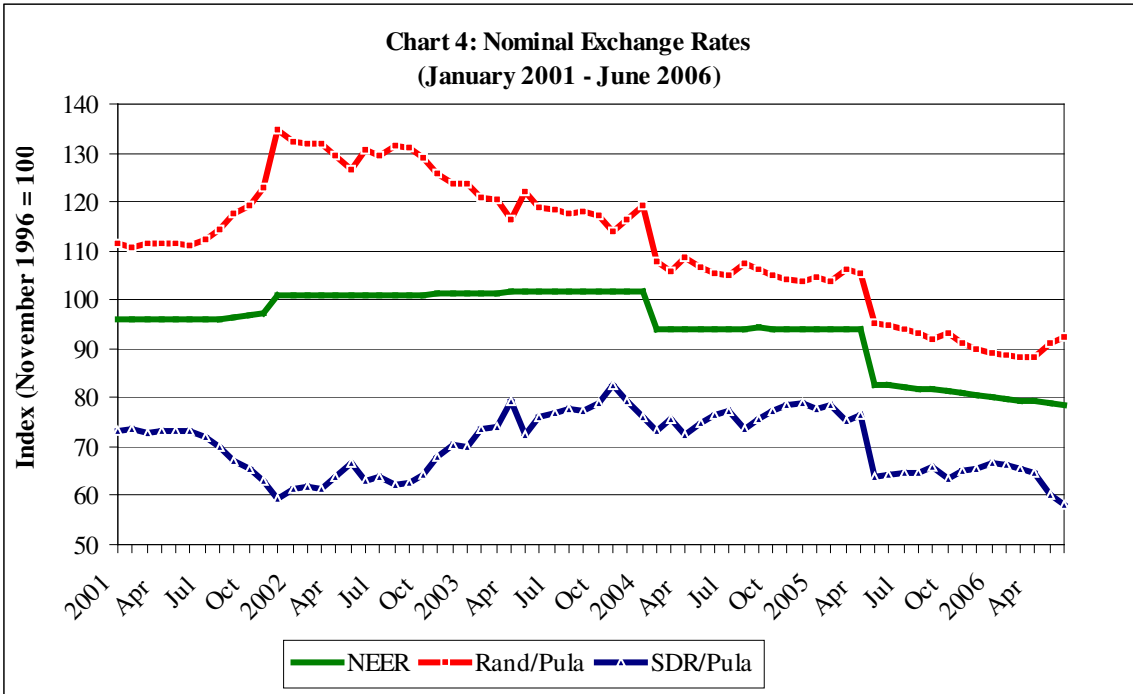
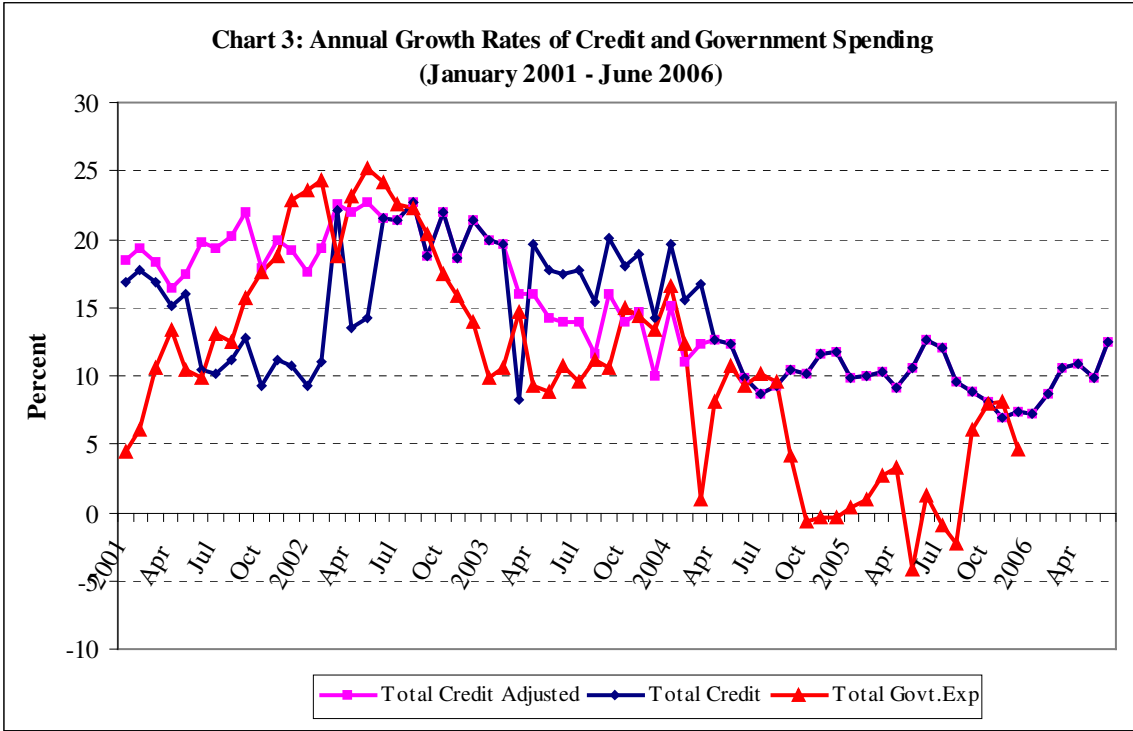
⁴ South Africa and the SDR countries (USA, Japan, UK and the euro zone).

⁵ The South African Reserve Bank's target measure of inflation, which excludes mortgage interest from the headline measure of inflation.



3.3 Domestically, the projected output growth of 4.2 percent in 2005/06 is much lower than the 8.3 percent attained in 2004/05. This is indicative of non-inflationary economic activity in the context of restrained growth in government expenditure and credit to the private sector. However, the year-on-year growth in commercial bank credit rose in the first half of 2006 (after falling in 2005), from 7.4 percent in December 2005 to 12.4 percent in June 2006 (Chart 3), although it remains within the Bank's desired range of 11 – 14 percent that is consistent with the Bank's annual inflation objective. The rise in credit growth in the first half of the year was against the background of a positive economic outlook engendered by the February 2006 Budget, which included the 8 percent increase in civil service salaries, net personal disposable income gains arising from tax adjustments and a budgeted 15 percent growth in government expenditure. These are, however, mitigated by the relatively restrictive monetary policy, which is aimed at containing inflation as it remains above the Bank's objective.

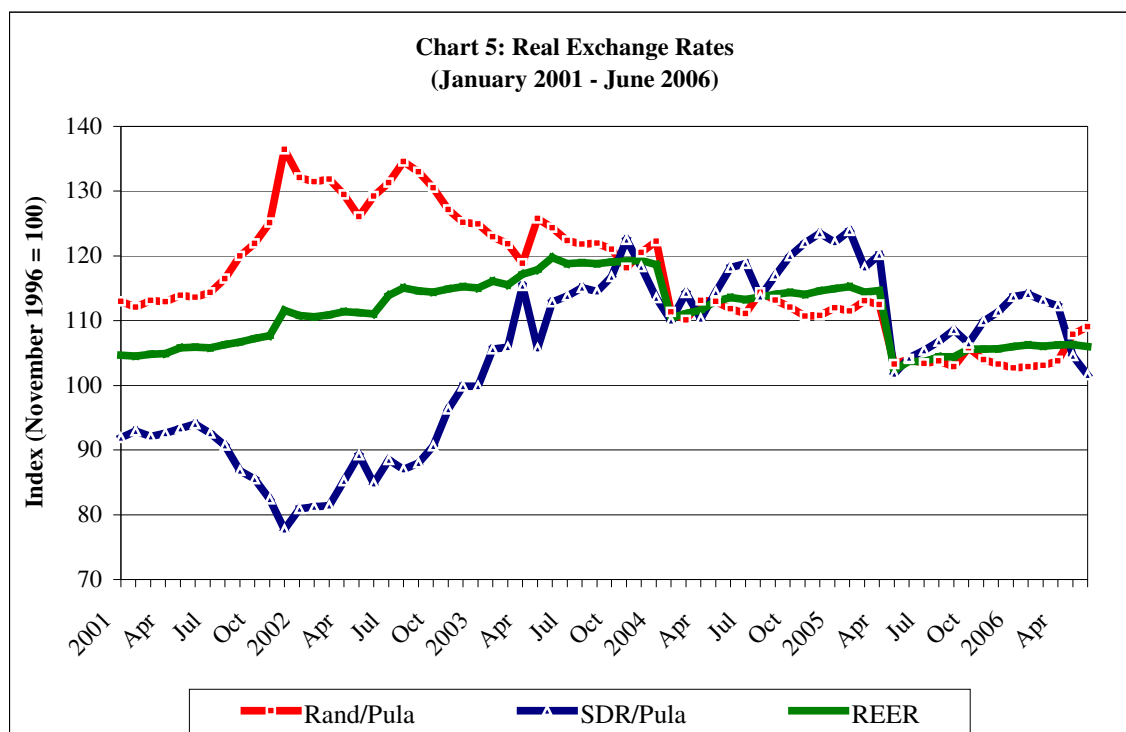
3.4 In the February 2006 Budget Speech, total government recurrent and development expenditure for 2005/06 was estimated to be 14.5 percent higher than in 2004/05. Recurrent expenditure was projected to grow by 14.8 percent in 2005/06, compared to 6.4 percent in 2004/05, while the estimated growth in development expenditure was 13.8 percent in 2005/06, in contrast to a contraction of 8.1 percent in 2004/05. However, recent data on actual government expenditure indicate a 4.6 percent annual growth to December 2005 (Chart 3), which suggests that the year-on-year increase in government spending in 2005/06 was lower than the 14.5 percent reported at the beginning of the year. Overall, fiscal policy supported monetary policy in an environment in which inflation was above the objective range.



3.5 In the context of the crawling band exchange rate mechanism, the Pula continued to crawl downwards, as domestic inflation remained higher than inflation in trading partner countries. However, bilaterally, the Pula appreciated against the

rand by 2.6 percent in the first six months of the year, thus mitigating the inflationary impact of the downward crawl. The rand depreciated against the major international currencies due to the increasing current account deficit which has been eroding investor confidence and resulting in capital outflow. It was also responding to a fall in commodity prices. Against the SDR, the Pula depreciated by 11.6 percent (8.7 percent against the US dollar) over the same period. As a result, the nominal effective exchange rate (NEER) depreciated by 2.6 percent in the six months to June 2006, while it depreciated by 5.1 percent year-on-year to the end of the first half of 2006.

3.6 Year-on-year to June 2006, the real effective exchange rate (REER) of the Pula appreciated by 2.1 percent⁶, and this was indicative of the rate of crawl not fully offsetting the inflation differential between Botswana and its trading partner countries. It is notable, however, that the differential is mostly due to the transitory impact of the devaluation and of the increase in administered prices, which together contributed about 5 - 6 percentage points to inflation.



4. Monetary Policy Developments

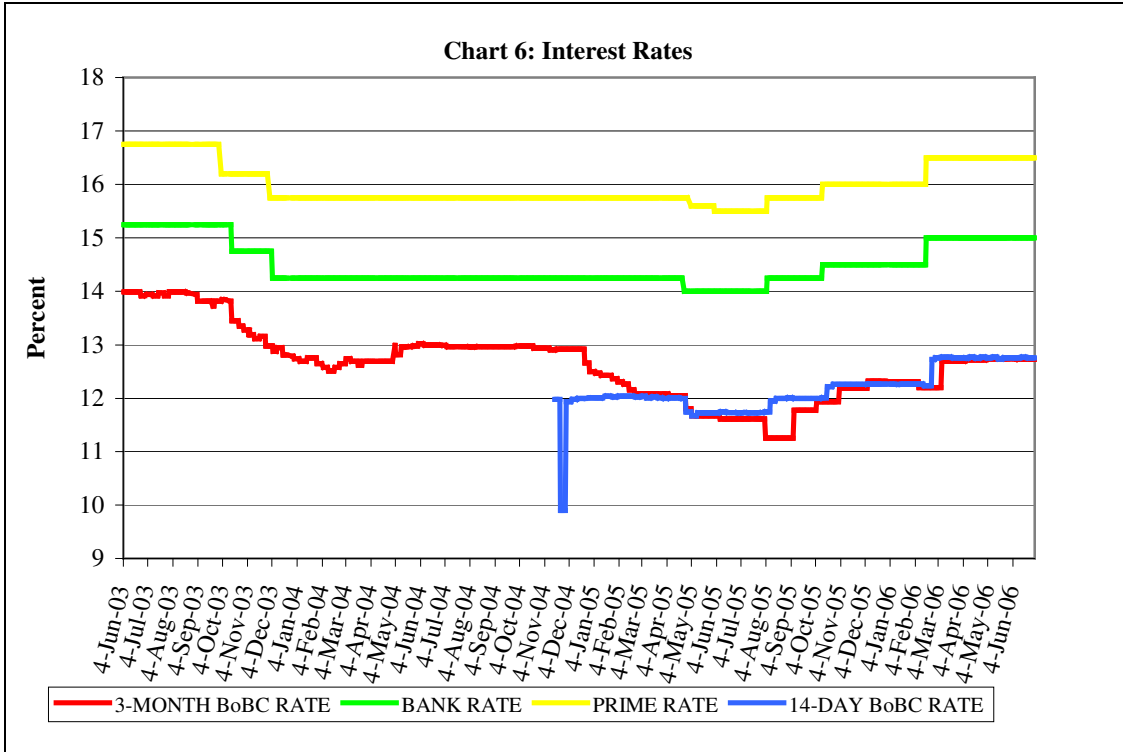
4.1 Monetary policy formulation in the first half of the year was conducted in the context of exceptional developments relating to the impact on inflation of the re-introduction of school fees in government secondary schools in January 2006.

⁶ Deflated using weighted average inflation for the SDR countries and South African CPIX inflation.

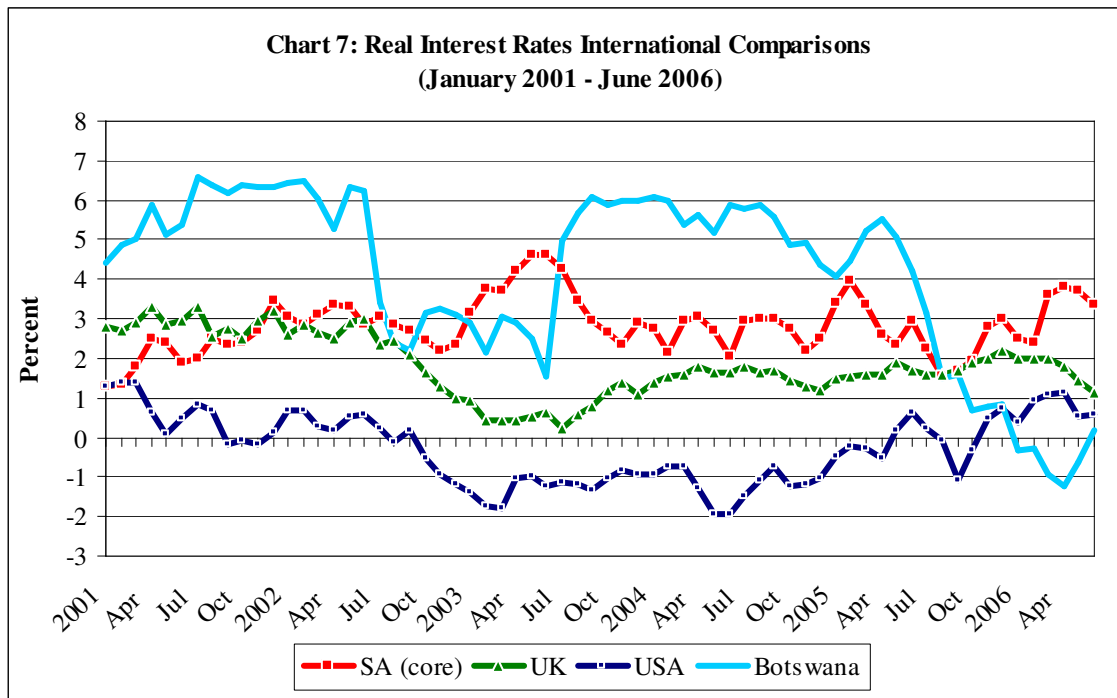
Initially, the Central Statistics Office estimated the contribution to inflation of the new school fees at 4.3 percentage points, hence generating a sharp increase in inflation to 16.6 percent in January 2006 and to 17.7 percent in March. Then the estimated impact was revised to about 1.1 percentage points; hence revised inflation peaked at 14.2 percent in April and fell in the next two months to 12.5 percent in June.

- 4.2 *Given the high inflation in the first half of the year, which was also forecast to remain above the annual objective in the short-term, the Bank maintained a restrictive monetary policy stance to sustain expectations of low inflation. While the Bank recognised that the high level of inflation was mostly due to transitory factors, it was considered important to reign in expectations of continuing high levels of inflation. Hence, the Bank Rate was increased by 50 basis points from 14.5 percent to 15 percent in February 2006.*
- 4.3 *In response to the policy action, the commercial banks increased the prime lending rate from 16 percent to 16.5 percent. However, the average 88-day deposit rate offered to retail depositors fell from 8.93 percent in December 2005 to 8.65 percent in June 2006. This reduction may reflect, in part, the increase in primary reserve requirements by the Bank, and the Bank's decision to confine the holding of BoBCs to commercial and merchant banks (effective March 2006).⁷ Overall, short-term interest rates increased, including the 3-month and 14-day BoBC rates which increased from 12.35 percent to 12.75 percent and 12.27 percent to 12.77 percent in December 2005 and in June 2006, respectively.*

⁷ *The increase in reserve requirements (unremunerated) may be the reason the commercial banks reduced deposit interest rates. The exclusion of non-banks from holding BoBCs led to an increase in deposits available to the banks, and possibly driving deposit interest rates down.*



Note: Effective May 1, 2004, the 3- month BoBC rate is the weighted average of successful bid yields at auction, while prior to that it was the average of the offer and the bid prices; hence it was called the '3 Months BoBC Mid rate'. As a result, the reported BoBC rate increased by 0.3 percent, which is a technical change.



4.4 *In an environment of relatively high domestic inflation, real interest rates in Botswana remain lower than comparable rates in South Africa⁸, UK and USA. The real 3-month BoBC rate fluctuated between -1.3 percent and 0.2 percent (Chart 7) during the first six months of 2006, mainly due to the upward trend in inflation for most of the first half of the year, and was 0.2 percent in June 2006, down from 0.8 percent at the end of December 2005. However, this should be viewed in the context of restrained policy tightening which recognised that the high inflation was mostly due to transitory influences and that demand was generally restrained. Moreover, the yield curve remains inverted and is indicative of expectations of low inflation in the medium to long-term, as well as local investors' demand for longer-dated instruments.*

5. Inflation Outlook for the rest of 2006

5.1 *While the sustained rise in oil prices remains a threat to global economic performance, its impact on output expansion has so far been low, and world GDP growth is forecast to rise from 3.3 percent in 2005 to 3.6 percent in 2006. While there is an upside risk to the general price level, global inflation remains low, in part because inflation expectations continue to be well anchored. World inflation is forecast at just below 3 percent for the whole of 2006; this reflects the effect of pre-emptive monetary policy action in some of the major economies in a bid to contain inflationary pressures and reinforce productivity improvements. Overall, it is considered that monetary policy is accommodative of output expansion.*

5.2 *In South Africa, output growth is expected to fall moderately from 4.9 percent of 2005 to 4.5 percent in 2006 due to a lower rate of growth in both mining and agriculture, although there are signs of recovery in the manufacturing sector. Despite the lower economic growth outlook, there are upside risks to inflation due to the expected rise in demand, the weakening of the rand and the high international oil prices. Nevertheless, CPIX inflation is forecast to remain within the South African Reserve Bank's target range of 3 – 6 percent in the short term, although it is projected to rise to 5 percent in the second half of the year. While the rand is expected to depreciate against the major international currencies, it is anticipated that it will fluctuate minimally vis-à-vis the Pula, even in the context of a downward crawl of the Pula exchange rate, with marginal impact on price developments in Botswana. Overall, it is expected that external inflationary pressures on inflation in Botswana will remain benign.*

5.3 *Domestically, it is anticipated that demand pressures will rise somewhat in response to the fiscal measures announced at the beginning of the year, including the budgeted 15 percent annual increase in government expenditure, the 8 percent rise in civil service salaries and the net income gain from personal tax adjustments. Nevertheless, both the growth in government expenditure and credit*

⁸ *The South African real rate is deflated by core inflation.*

to the private sector in the second half of 2006 are expected to be consistent with the Bank's annual inflation objective.

- 5.4 *Inflation fell for the first time in May this year since April 2005, and is forecast to decline further towards the upper end of the inflation objective as the impact of the May 2005 devaluation falls out of the inflation calculation in the second half of the year. In addition, widening the coverage of zero-rated commodities for VAT which took effect in July 2006 should lessen the upward pressure on inflation. The rebasing of the CPI basket may also impact on the inflation measure by reducing the upward bias which leads to over-estimations of inflation which outdated price indices typically entail. There are, nevertheless, significant upside risks to inflation arising from possible further increases in fuel and other administered prices, including the rebalancing of tariffs by Botswana Telecommunications Corporation⁹ and a likely increase in public transport fares.*

6. Monetary Policy Stance

- 6.1 *At the beginning of the year, the Bank set the annual inflation objective at 4 – 7 percent and the medium term inflation objective at 3 – 6 percent. The introduction of the medium-term inflation objective was in recognition of the lag between a policy change and its impact on the ultimate objective. In addition, the medium term inflation objective affords the Bank sufficient time to direct its policy actions to the sources of inflation that it can influence, particularly in the context of continuing price adjustments by parastatals and cost recovery measures by the Government.*
- 6.2 *The annual inflation objective derived from forecast trading partner inflation is 4 – 5 percent. It is, however, considered appropriate to maintain the 4 – 7 percent objective. In the absence of large increases in administered prices, domestic inflation is expected to decrease and be closer to the upper end of the annual inflation objective of 4 – 7 percent by the end of 2006, especially as the impact of the devaluation falls out of the inflation calculation and demand pressures continue to be restrained. The maintenance of the 4 – 7 percent inflation objective should help in reinforcing the Bank's desire to achieve low inflation through a gradual adjustment path without undermining sustainable economic growth. Meanwhile, the downward crawl of the exchange rate would complement monetary policy towards achieving stability of the REER. The desired range for credit growth, consistent with the inflation objective, is 11 - 14 percent. This implies that government expenditure should also grow moderately for overall demand conditions to be consistent with the inflation objective.*

⁹ *The re-balancing will result in a rise in telephone tariffs for line rentals and local calls that are included in the CPI basket (thus adding to inflation) and a decrease in tariffs for international calls, which are not included in the basket.*

7. *Summary and Conclusions*

- 7.1 *Inflation rose in the first four months of 2006, due to the increase in administered prices, notably the re-introduction of school fees in government secondary schools in January and fuel price increases. Inflation has, however, begun to fall and this trend is expected to continue as the effect of the May 2005 devaluation drops out of the inflation calculation, and international inflationary pressures remain benign and demand pressures are contained by a relatively restrictive monetary policy. Inflation is, however, expected to remain above the upper limit of the objective range of 4 – 7 percent for the rest of 2006.*
- 7.2 *Inflationary pressures are restrained globally by monetary policy tightening in major economies, competition and productivity improvements which tend to moderate the upward inflationary pressure resulting from oil price increases. In South Africa, CPIX inflation is forecast to remain within the target range of 3 – 6 percent in the second half of the year, although there are significant upside risks due to the rise in consumer demand, oil price increases and the weakening rand. Domestically, it is anticipated that the increase in demand underpinned by the expansionary fiscal policy outlined in the 2006/07 Budget will not be inflationary, as demand will be rising from a low base.*
- 7.3 *For the remainder of the year, the annual inflation objective range will be maintained at 4 – 7 percent. The Bank will aim to ensure that inflation arising from underlying demand pressures remains close to this level and that any inflationary pressures arising from second-round effects of the increase in administered prices and inflation expectations are contained. As usual, the Bank will continue to monitor developments and will take appropriate monetary policy action should it be necessary to do so.*