

## **MONETARY POLICY STATEMENT - 2000**

### **INTRODUCTION**

This is the third consecutive year that the Bank of Botswana is releasing a Monetary Policy Statement to the public. The Statement serves two purposes. First, it provides a framework within which the Bank's monetary policy activities are developed and implemented; and second, it informs the wider community about the Bank's policy objectives, in order to foster a broader understanding of policy actions that may be undertaken throughout the year.

Monetary policy has two principal objectives in Botswana - to achieve price stability as reflected in a low and stable rate of inflation, and to maintain positive real interest rates (after allowing for inflation) that are comparable to those prevailing in major international financial markets. The need to maintain competitive interest rates has become particularly important since the abolition of exchange controls, a situation which allows free movement of capital. Positive real interest rates promote capital inflows and encourage domestic financial savings, both of which are essential for financing investment.

In Botswana, as in any economy, there are four major categories of expenditure: domestic private consumption, government consumption, investment by both the Government and the private sector and net exports. If total expenditure grows more rapidly than available goods and services, inflation will rise. Monetary policy affects some of these expenditure categories, but not all of them. It is for this reason that monetary policy is implemented most effectively within a balanced macroeconomic policy framework.

When viewed against the background of the 1999 economic and financial performance, the thrust of monetary policy during 2000 will be to consolidate the policy actions taken in the course of 1999, which resulted in a slowdown in the rate of credit expansion and a corresponding progressive reduction in inflation in the last few months of the year. Overall, the aim is to reduce inflation further, in order to sustain and enhance the regional and international competitiveness of Botswana's producers.

### **OVERVIEW OF 1999**

#### **Economic Performance**

Botswana's rate of economic growth slowed to 4.2 percent in 1998/99 after a very strong performance in 1997/98 when the economy expanded by 8.0 percent. The slowdown in economic growth was explained mainly by the decline in the performance of the mining sector, where output fell by 4.4 percent. While there was some recovery of diamond sales during 1999, it came too late to influence production during the 1998/99 national accounts year. Nevertheless, very large increases in diamond sales in the last quarter contributed to a substantial rise in diamond exports in 1999 compared to 1998, which resulted in an increase in the foreign exchange reserves of approximately 10 percent to P28.9 billion. In contrast to the slowdown in the mineral sector, non-mining activity performed much better during 1998/99, expanding by 8.9 percent, compared to 7.2 percent in 1997/98. Several sectors, including water and electricity, transport, trade, construction as well as finance and business services, experienced growth rates in excess of 10 percent.

Although the overall economic growth rate slowed, healthy economic activity in the non-mining sector of the economy gave rise to price increases in several sectors, especially construction and some services. In addition, the rise in expenditure following the increase in public sector salaries in 1998 added to inflation, as the impact of the rise in labour costs spread throughout the economy. The growth in expenditure was reflected in high rates of credit expansion, the rise in public spending and the Government budget deficit in the 1998/99 financial year. Furthermore, the increase in import prices added to the upward movement of domestic prices, following an average increase of 8.1 percent in the cost of imported goods during the year; the import cost, in turn, largely reflected the high level of core inflation in South Africa.

As a result of various factors, inflation in Botswana averaged 7.2 percent during 1999, compared to 6.5 percent in 1998. This increase in inflation was disappointing, as it reversed the downward trend that the country had experienced since 1993. It also contrasted with the objective that was laid out in the 1999 Monetary Policy Statement of a lower inflation rate, and demonstrated the difficulties inherent in relying on monetary policy to achieve inflation objectives when this is not

supported by an appropriate and complementary fiscal policy. The one encouraging sign was that the last quarter of 1999 contained three successive months of falling inflation, from 7.6 percent in September to 6.9 percent in December.

The real exchange rate of the Pula, which takes account of inflation in Botswana and its major trading partners, was relatively stable throughout the year, with little change against both the US dollar and the South African rand. However, it appreciated by around 4 percent against a basket of major international currencies, as measured by the Special Drawing Right (SDR), an accounting unit of the International Monetary Fund (IMF). The appreciation against the SDR represented a small deterioration in the competitiveness of Botswana producers in international markets, and was a combined result of the stability of the non-inflation adjusted exchange rate of the Pula against major international currencies during the year, while inflation in Botswana was relatively high by international standards.

With regard to public spending, the preliminary Budget Estimates indicate that Government expenditure increased by 26 percent in 1999/2000 compared to 1998/99. While this growth rate was very high, the inflationary pressures caused by such a rapid increase in spending were moderated by the fact that a budget surplus of P510 million is projected for the 1999/2000 financial year. As a result of the surplus, Government deposits accumulated at the Bank of Botswana, a development which tends to reduce the growth of expenditure in the economy as a whole.

### **Monetary and Credit Developments**

One of the main factors which drives expansion in expenditure is the growth of bank lending, as a means of financing both private consumption and investment. As indicated in last year's Monetary Policy Statement, credit rose by 55 percent in 1998, a rate of increase that was excessive, unsustainable and inflationary. However, during 1999, there was a decline in the rate of credit expansion to 41 percent, partly as a result of the restrictive monetary policy measures undertaken by the Bank during the year.

The growth of credit to households slowed down slightly, from 46 percent in 1998 to 44 percent in 1999, while the increase in credit to the private business sector declined more rapidly, falling from 44 percent in 1998 to 26 percent in 1999. Although the downward trend in credit expansion during the year was welcome, bank lending, especially to household borrowers, was still above sustainable levels and contributed to the rise in inflation during the year.

In response to both monetary policy and an overall slowdown in economic activity, all measures of money supply grew more slowly in 1999 than in 1998.

### **Monetary Policy Implementation in 1999**

There were indications early in 1999 that inflationary pressures were building up following a high rate of expansion in overall spending during 1998/99. In order to restrain expenditure growth, and thereby reduce inflation, monetary policy was tightened moderately during 1999. Accordingly, the Bank Rate was raised from 12.50 percent to 12.75 percent in January and to 13.25 percent in March, and there were commensurate increases in interest rates on Bank of Botswana Certificates (BoBCs) and repurchase agreements (repos). The commercial banks correspondingly adjusted their lending rates upward. In order to sustain the tight monetary policy stance, nominal interest rates were not reduced when inflation fell from 7.5 percent in September 1999 to 6.9 percent in December 1999; as a result, real inflation-adjusted interest rates rose slightly.

It is important to point out that the use of monetary policy tools, especially increases in interest rates, was restrained considerably in the face of very high credit growth rates. Restraint was exercised because the rise in interest rates that would have been necessary to significantly reduce credit expansion would have raised the cost of financing investment and slowed down economic growth further. Therefore, monetary policy implementation in 1999 attempted to maintain a careful balance between meeting the objective of lower inflation while avoiding the potential negative impact of high interest rates on private sector investment that is the basis of economic diversification.

As in the past, excess loanable funds, or excess liquidity, at the disposal of the banks were absorbed through the issuance of BoBCs. During 1999, the value of BoBCs outstanding increased by 30 percent (to P4.4 billion), in contrast to 1998 when the value fell by 4 percent. Most of the rise in excess liquidity took place towards the end of the year, and was mainly a

result of increased diamond export receipts. Interest rates on BoBCs rose during the year, in tandem with the increases in the Bank Rate. Besides the use of Open Market Operations (using BoBCs), the Bank utilised repurchase agreements (repos) with the commercial banks to control excess liquidity in the banking system.

Although inflation remained relatively high while anti-inflation measures took effect, the competitiveness of real interest rates (after adjusting for inflation) was maintained. The three-month money market rate, which was in the 3.3-4.4 percent range, compared favourably to an average of 2.62 percent in the USA and 3.32 percent in the UK.

### **ECONOMIC AND FINANCIAL PROSPECTS FOR 2000/2001**

Expectations for 1999/2000 are that growth in the non-mining sector of the economy will be approximately 7 percent, while overall economic expansion is projected to be around 10 percent. Overall growth will be supported by the recovery of the mining sector with the expansion of diamond production at the Orapa Mine, as well as the anticipated recovery in regional and global export markets. However, it is likely that there may be a slowdown in economic growth in the non-mining sector during the second half of 2000 as the impact of slower growth of Government spending in the 2000/2001 financial year takes effect.

Economic growth is expected to be buttressed by the buoyancy of the world economy which is forecast to expand by approximately 3.5 percent in 2000 compared to 3 percent estimated for 1999. World economic growth will be largely driven by the expected continued expansion of the US economy, prospects of economic recovery in Japan and the strengthening of economic performance in the Euro zone. For developing countries, growth is expected to accelerate to 4.8 percent in 2000 with improved performance of the Asian and Latin American economies. As far as the Southern African region is concerned, the South African economy is forecast to expand by 3.5 percent, a significant improvement from the 1.5 percent growth estimated for 1999; growth prospects for Zimbabwe are not good, at least in the short term.

The outlook for global inflation is for a slight increase, as oil price increases in 1999 feed through to production costs generally. This factor is likely to be reinforced by increased expenditure arising from a recovery in world economic growth. However, it is expected that productivity gains and pre-emptive anti-inflation policies in industrialised countries, as well as appropriate macroeconomic policies in developing countries, will restrain the expected increase in inflation in 2000.

### **MONETARY POLICY FOR 2000**

There remains a pressing need to bring down Botswana's inflation to a level that is closer to inflation rates in the major industrialised economies. A reduction of inflation will help to support economic diversification by bringing greater stability to the macroeconomic environment within which investment decisions are made. An important aspect of the diversification effort is the need for Botswana to maintain competitiveness against its trading partners without having to resort to exchange rate devaluations.

For this reason, the focus of monetary policy in 2000 is to restore the downward trend in inflation that was established between 1993 and 1998. This will certainly involve reducing inflation below the 1999 average of 7.2 percent, and preferably lower than the 6.5 percent experienced in 1998. The inflation objective implies that short-term interest rates will probably need to be maintained at existing levels in relation to Botswana's major trading partners, after taking into account relative inflation. Besides the beneficial macroeconomic effects, controlling inflation will enhance the competitiveness of the Pula against major trading partner countries.

In order to achieve the objectives of exchange rate competitiveness (after allowing for inflation) and a lower rate of inflation, the Bank will closely monitor credit growth while the Government's fiscal policy will need to adhere to the desired and complementary rate of increase in expenditure.

Although the reduction in credit growth during 1999 was in the right direction, it will need to be reduced further to sustainable levels, if the desired level of inflation for 2000 is to be achieved.

The growth rate of Government spending in 2000 will need to remain within the projected levels. The 2000/2001 fiscal year expenditure levels are expected to be non-inflationary. Projections are for a balanced budget and a significant reduction in the growth of public spending in the 2000/2001 financial year with an increase of only 3 percent before the granting of any

supplementaries or the public sector pay increase. This expected result will allow the burden of containing inflation to be shared between fiscal and monetary policies, in contrast to previous years when reliance was primarily on monetary policy.

It is anticipated that excess liquidity will increase during the year, due mainly to the foreign exchange inflows that will result from the expansion of diamond production and exports. This liquidity will be absorbed, as necessary, through the issuance of BoBCs and an increase in deposits at the Bank of Botswana. The Bank will, to the extent possible, devise the means of absorbing excess liquidity at a lower cost to the Government than is presently the case. To this end, the Bank will explore and put in place, as appropriate, structural reforms of the payment and disbursement arrangements affecting Government funds.

With respect to interest rates, the Bank is aware of concerns about the high level of interest rates charged on loans. For instance, the commercial bank prime lending rate is currently at 15.25 percent compared to inflation of 7 percent. The Bank is sensitive to the need for lower interest rates. However, monetary policy will, of necessity, remain tight until there is conclusive evidence that inflation is coming down, and that the growth of bank credit and the associated rise in expenditures have abated. Fortunately, the last few months of 1999 indicate that progress is being made on both these fronts.

### **CONCLUSION**

The Bank will continue to treat reduction of inflation as its primary objective. While there have been substantial achievements in recent years, given that inflation peaked at 17.7 percent in June 1992, there is still considerable room for improvement. Lower inflation is an essential component of both macroeconomic stability and international competitiveness, and both are prerequisites of successful economic diversification. In order to achieve this goal, the Bank will monitor monetary and financial conditions throughout the year with a view to determining the necessity, or otherwise, of adjusting the levers of monetary policy implementation. It is pleasing that fiscal policy during this year is supportive of inflation reduction, and that monetary and fiscal policies will be working in a complementary manner. Although monetary policy will need to remain tight until inflation falls further and credit growth is back to sustainable levels, there are good prospects that the favourable trends, which we all desire, will occur during this year.