

2005 MONETARY POLICY STATEMENT

by

Linah K Mohohlo
Governor

February 21, 2005

Honourable Ministers

Honourable Members of Parliament

Members of Diplomatic Corps

Distinguished Ladies & Gentlemen

As has become customary with the release of the annual Monetary Policy Statement, which this year is the seventh in the series, my remarks will provide a brief review of inflation trends during the past year. I will also share with you the assessment of the extent to which the Bank, through implementation of its monetary policy, succeeded in meeting the inflation objective that was set for 2004 and was announced around this time last year. This will be followed by the Bank's outlook for the economy and financial developments for 2005 and, based on that, I will advise you on the policy stance to be adopted by the Bank in the course of the year.

Since my remarks provide only the main highlights of the 2005 Monetary Policy Statement, I encourage you to obtain a copy of the full Statement so that you familiarise yourselves with the details of the various issues covered. It is very important that you spare some time to read the full Statement and, later in the year, its mid-term review, because the Bank is committed to communicating its activities to all stakeholders, the general public included. It goes without saying that a broader

understanding by all economic agents of the context in which the Bank formulates and implements its monetary policy objectives helps to strengthen its effectiveness to the ultimate benefit of the nation.

Before I begin the review of the 2004 inflation and financial trends, and the policy stance taken by the Bank in response to the situation that prevailed at the time, I wish to highlight what the Bank's **monetary policy framework** is all about. I begin with the policy objective.

It is now generally known and accepted that the principal objective of monetary policy in Botswana, and for almost all countries and central banks, is the achievement of a sustainable, low and predictable level of inflation. It is for this reason that the legislated mandate of the Bank stipulates that, through its monetary policy, the Bank is to "promote and maintain monetary stability". In the Bank's view, monetary stability must be reflected in price stability which, in turn, is achieved when inflation is low and stable. Although it is largely an empirical question as to how low and stable inflation must be for prices to be considered stable, many experts agree that prices are stable when inflation is sufficiently low to the extent that it no longer significantly distorts economic decisions to consume, produce or save.

There is, of course, room for debate about what level of inflation this might be in Botswana, but I am sure most of you would agree that the current inflation of 8 percent is not low, in relative terms, and, therefore, does not represent price stability. It is against this background that the Monetary Policy Statement, the contents of which I am about to summarise, lays out how the Bank intends to address the problem of the

prevailing level of inflation in the country in order to achieve the objective of price stability during 2005.

As we are all aware, achieving and maintaining a low level of inflation is not an end in itself. Rather, it is a means by which the Bank, through monetary policy, contributes to the ultimate national objective of improving the economic well-being of the nation. This is so because low inflation supports the maintenance of international competitiveness of domestic exporters which is a key component of the Government's economic diversification policy. Such competitiveness cannot be achieved on a permanent basis, unless, among other factors, inflation is at least comparable to, or lower than, that of Botswana's major trading partner countries.

The success of monetary policy in containing inflation for competitiveness reasons is particularly important in the context of the current pegged exchange rate regime of the Pula, because a persistently higher level of inflation in Botswana than that of her competitors increases pressure to devalue the currency. While devaluation may be an appropriate response in some limited circumstances, it must be kept in mind that it is, in turn, inflationary as it raises the cost of imported consumer and capital goods which the country needs. Ultimately, therefore, devaluation works against achieving export competitiveness and the economic diversification objective. The Bank's focus on low and stable inflation reflects not only the national objective of export-led growth and economic diversification, but also the Bank's own statutory objective of achieving and maintaining monetary stability.

In this regard, it is important to mention that the task of monetary policy in containing inflation would be made immensely easier by the success of the combined efforts of both the private and public sectors in improving productivity. An increase in productivity is, in the end, the only way a country can fundamentally improve export competitiveness as well as generally achieve and sustain an improvement in overall living standards. Hence the Bank welcomes and supports all initiatives of both the Government and private sector groups that seek to make the country's economy more productive. Not only would such efforts make the Bank's primary task easier to pursue, they would also address other more fundamental economic challenges facing the country.

I now wish to highlight some issues relating to the **Annual Objective for Inflation**.

On an annual basis, the Bank aims at achieving a level of inflation that, after taking into account the effects of any change in the nominal exchange rate will, at a minimum, contribute to maintaining relative stability in the real exchange rate, which is one commonly used indicator of international competitiveness. This means that the annual inflation objective must be reflective of an assessment of the outlook for inflation in trading partner countries, importantly South Africa, but also the US, UK and the Euro-zone.

Inflation trends in these countries in recent years have implied an annual inflation objective for the Bank of between 4 percent and 6 percent, with a bias towards the lower end of the range because of the general slow-down in global inflation. You may recall that the desired range of inflation announced by the Bank for 2004 was marginally higher at 4

percent to 7 percent, because of the need to accommodate a portion of the direct effects of last February's devaluation of the Pula. The change in the desired inflation range in 2004 was designed to allow reasonable room and time for the economy to adjust to the higher import costs arising from the devaluation, while ensuring that the potential gain in competitiveness that the devaluation intended to achieve would not be eroded quickly by a significant rise in inflation.

Adjustments in the desired annual inflation ranges are consistent with the Bank's aim of bringing inflation down over time, to the longer-term goal of a stable and steady path, but at a measured pace. Changing economic circumstances, such as last year's devaluation of the Pula and recent international oil price developments, will influence how quickly inflation can be brought back on track. Despite these developments, I can assure you that the Bank remains fully committed to achieving the objective of low and stable inflation.

At this point, a few words about the **role of interest rates in the Bank's monetary policy** would seem appropriate, for one cannot appreciate the essence of monetary policy without linking it with interest rates. To most people, consumers and businesses alike, monetary policy is all about the rate of interest, either that which is earned on saving and investment, or paid on borrowed funds, all of which is understandable and related to the Bank's use of interest rates to pursue its inflation objective.

Changes in interest rates, as well as changes in other policies, in particular fiscal and exchange rate policies, affect the overall level of expenditure on goods and services as well as decisions to save and invest. That is why interest rates are the Bank's key instrument in

deciding on its monetary policy stance, because when total expenditure from all sectors of the economy (consumers, businesses, government and exporters) exceeds the supply of goods and services in a given period, then prices rise at a rapid pace. Although all sectors of the economy are important when considering whether domestic demand is at a level that is inflationary, the Bank also pays particular attention to the growth rate in Government spending because of its relatively large share and influence in overall flows of expenditure in the economy. This is a fact that underscores the need for consistency and complementarity between fiscal and monetary policies in achieving low and sustainable inflation.

Given this approach to implementing monetary policy, the level of interest rates at any particular time will reflect the Bank's best judgement on the existing and prospective inflationary pressures in the economy. Both nominal and real interest rates will be higher than normal in periods when inflationary pressures are strong, and lower than normal when these pressures are weak or weakening. Normally, low interest rates would be expected to prevail once price stability has been achieved, and will broadly reflect Botswana's underlying economic situation.

Nevertheless, in making decisions on the level of interest rates needed to achieve the inflation goals, the Bank takes the needs and interests of both savers and investors into account. It is for this reason, that interest rates cannot be set to favour one group or sector of the economy over another without undermining the chances of achieving the Bank's broader economy-wide objective of monetary stability. On the contrary, a broad based application of the Bank's monetary policy instruments to achieve and maintain low inflation helps create an overall enabling

environment for a progressive move towards low interest rates that favour both saving and longer term productive investment which, in turn, strengthens the growth of the economy and its capacity to generate new jobs on a sustainable basis.

I now turn to a review of **economic and financial developments in 2004** that had a bearing on inflation in Botswana, and the monetary policy actions that were taken.

As I mentioned earlier, the Bank's desired inflation objective for 2004 was slightly wider than that of the previous two years, at 4 percent to 7 percent. This was to allow room for the economy to adjust to the initial increase in imported inflation arising from last year's 7.5 percent devaluation of the Pula which, when combined with the increase in administered prices, led to the annual inflation rising from 6.4 percent in December 2003 to 7.8 percent in December 2004. As you know, it rose further last month to 8 percent.

It is estimated that the devaluation contributed about 2 percentage points to the inflation outcome to date, as a result of higher Pula-denominated import prices. Moderately higher inflation in Botswana's major trading partner countries was also a factor which put upward pressure on import prices, although the decline in South Africa's inflation in the second half of the year helped mitigate somewhat the extent of the rise in domestic prices.

Administered prices also affected inflation in 2004. The main factor behind the rise in these prices was the substantial increase in international oil prices, which necessitated several upward adjustments

to fuel prices by the Government during the year. Cumulatively, fuel prices added 1.3 percentage points to inflation. In addition, the substantial upward adjustment of transport fares and some telephone charges contributed approximately one percentage point to inflation. Overall inflation, excluding items with administered prices, which constitute about a sixth of the consumer price index basket, is estimated at between 5.5 percent and 6 percent in 2004, well within the inflation objective of 4 percent to 7 percent.

In contrast to other factors that caused a rise in inflation, domestic demand eased and exerted a dampening effect on inflation during 2004 as growth in both credit and government expenditure was below the ranges considered consistent with the inflation objective. The twelve-month rate of expansion in commercial bank credit slowed from 14.2 percent in December 2003 to 11.8 percent in December 2004. The slow-down in credit occurred in the context of a restrained rise in overall government expenditure and the maintenance of high interest rates by the Bank. However, the 15 percent average increase in public service salaries, announced in last year's Budget, contributed to a doubling of the annual growth of credit to households, from 11 percent in December 2003 to nearly 22 percent in December 2004. This increase in demand for credit by households took place despite the modest erosion of real wages over the preceding two years, increasing debt levels, and the rise in prices following the devaluation. Borrowing by businesses on the other hand increased very little year-on-year, with credit demand from this sector subdued by the slower increase in government spending during the year, and more moderate business activity generally, and by the fact that, in periods of high interest rates, businesses tend to increase reliance on the use of internal savings to finance expansion.

As for government spending, budget estimates suggest an increase of just over 10 percent in the fiscal year about to end next month, which is only moderately higher than the rate of growth for 2003/04 of approximately 9 percent. It is indeed laudable that the government expenditure growth rates for both fiscal years lie within the range considered consistent with the Bank's inflation objective.

In the event, therefore, fiscal policy was generally supportive of monetary policy in an environment in which inflationary pressures arising from the devaluation and an increase in administered prices were relatively strong and increasing.

The net effect of all these various factors on inflation was that it remained within the objective range of 4 percent to 7 percent for most of 2004, rising through the 7 percent upper end of the range only towards year-end. It was against this background that monetary policy remained restrictive in order to sustain expectations of an eventual decline in inflation back towards the Bank's inflation objective.

Despite the higher inflation in Botswana compared to what prevailed in trading partner countries, the real effective exchange rate depreciated by 7.5 percent earlier in the year, as a result of the nominal devaluation of the Pula. By the end of the year, the extent of the depreciation had narrowed to 4.5 percent due to the subsequent rise in inflation which eroded the initial positive impact of the depreciation of the Pula. This point illustrates the fact that lasting international competitiveness of domestic producers, as reflected in the real exchange rate, can be

achieved only through attaining a level of inflation that is lower than that of trading partner countries, among other factors.

Distinguished Ladies & Gentlemen,

What of the Bank's **Outlook for Inflation and Monetary Policy for the Year 2005?**

Looking ahead, current inflationary pressures are expected to moderate during 2005 and, in the absence of any further significant increase in administered prices or an adverse change in the Pula exchange rate, inflation should begin to come down as the effects of last year's devaluation and the upward adjustments of administered prices drop out of the inflation calculation.

Globally and regionally, inflation is forecast to remain low, especially in South Africa, where it is expected to remain within that country's target range. Although oil prices increased to record levels in 2004, thus contributing to a weakening of global demand, they had begun to ease by year-end, in part due to the Organisation of Petroleum Exporting Countries' commitment to keep prices at sustainable levels through output expansion. Be that as it may, oil prices remained high by historical standards, at least in US dollar terms. Despite this unfavourable influence on prices, inflation is generally under control in major economies due to an increase in productivity and continued strong competition in the goods markets. Wage pressures are also subdued and pre-emptive monetary policy tightening by major central banks is

having the desired effect on inflation in developed economies. Hence average inflation in major industrial countries is forecast to decline from 2.6 percent in 2004 to around 2 percent in 2005.

Domestically, the fiscal outlook and current interest rate policy imply that domestic demand pressures will continue to be subdued. Both the moderate growth in overall government expenditure, announced in the Budget earlier this month, and the absence of a salary increase for civil servants should help sustain the current rates of credit expansion which are considered consistent with the inflation objective. Real GDP growth is also expected to slow to between 4 percent and 5 percent this year due to reduced activity in both the mining and non-mining sectors. On the whole, all indicators so far suggest that domestic inflationary pressures can be expected to be benign in 2005.

Hence the Bank has concluded that an inflation objective of **3 percent to 6 percent**, which at the lower end relates directly to expected trading partner countries' inflation, would be appropriate and consistent with the aim of ensuring relative real exchange rate stability in the short-term. The 3 percent to 6 percent inflation objective should also contribute to achieving the Bank's longer-term objective of low and stable inflation. The upper end of the 2005 inflation objective of 6 percent, while slightly above the higher end of the range forecast for trading partner countries' inflation, is consistent with the desire to bring inflation down on a stable, steady path, and at a measured pace.

The Government Budget for fiscal year 2005/06 entails growth in government spending that is supportive of the inflation objective, which means that fiscal policy will remain generally complementary to

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, and would support the Bank's efforts to achieve its inflation objective.

While the Bank's ultimate primary target is inflation, it also has an intermediate target for the rate of growth of bank credit to the private sector. 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 percent to 6 percent** inflation objective is **10 percent to 13 percent**. The desired credit expansion range is derived from the Bank's estimate of the increase in available goods and services in the country, proxied by the rate of growth of the non-mining sector of the economy, and the desired inflation level for the year, with an allowance for the process of financial deepening as the economy develops.

Honourable Ministers

Honourable Members of Parliament

Members of Diplomatic Corps

Distinguished Ladies & Gentlemen

I **conclude** by summarising the outlook for the next 12 months and the policy challenges it presents.

Global economic growth improved in 2004 following a sluggish performance in the past few years, but it is expected to slow moderately

in 2005. World inflation should remain under control, especially if the recent oil price decline persists. There should, therefore, be minimal external upward pressure on domestic inflation in 2005. This is supported by expectations of moderate growth of government expenditure and credit expansion. 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 in the exchange rate that may have an impact on import prices.

Against this background, the challenge for monetary policy in 2005 is to ensure that the anticipated decrease in inflation is realised and contributes towards achieving the Bank's objective of low and sustainable inflation. In such an environment, the Bank will conduct monetary policy with the objective of ensuring that inflation falls within the desired range of 3 percent to 6 percent by the end of the year. In order to fulfil its mandate, the Bank remains committed to responding in an appropriate and timely manner to all economic and financial developments as they relate to keeping inflation in check.

This concludes my presentation of the 2005 Monetary Policy Statement, and I thank you all for your kind attention.