# MONETARY POLICY STATEMENT 2017

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## *2017 MONETARY POLICY STATEMENT*

## *1. INTRODUCTION*

*1.1 The Monetary Policy Statement (MPS) is the Bank of Botswana's main medium through which stakeholders are informed of the framework for the formulation and implementation of monetary policy. Through the MPS, the Bank reports inflation trends, policy performance and the Bank's policy choices for the ensuing year. It also serves to fulfil the public's expectation of a transparent and accountable central bank in implementing the monetary policy mandate entrenched in the Bank of Botswana Act (Cap 55:01).*

*1.2 The 2017 MPS reviews 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. The Statement also makes an assessment of economic and financial developments that are likely to influence the inflation path in the medium term and, in turn, the Bank's policy choices in 2017. Price developments and policy options are evaluated in the context of a forward-looking monetary policy framework and 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 the conduct of monetary policy in order to anchor public expectations of a low, predictable and sustainable level of inflation.*

*1.3 Global economic activity was weak in 2016 relative to 2015, with varying performance across countries and regions. In advanced economies, growth in output slowed, weighed down by ongoing structural adjustments, policy uncertainty and slower growth in global demand and trade. In the emerging markets, output growth was unchanged in the same period, reflecting the combined outcome of slowdown in economic activity in emerging Asia and some improvement in hitherto contracting economies, particularly Brazil and Russia. Furthermore, some emerging market economies continued to experience weak demand, tighter external financing conditions and low commodity prices. Global inflation remained low in 2016, mainly as a result of subdued commodity prices (notably oil prices), modest global demand and persistent spare capacity in advanced economies. Consequently, for major central banks, monetary policy remained accommodative, with low interest rates and provision of liquidity to the financial sector. Similarly, some emerging market economies eased monetary policy to boost economic activity as inflationary pressures dissipated.*

*1.4 In Botswana, real GDP expanded by 0.9 percent in the twelve months to September 2016, underpinned by growth in non-mining output. Inflation was below the lower end of the Bank's medium-term objective range of 3 – 6 percent for most of 2016 and decreased from 3.1 percent in December 2015 to 3 percent in December 2016. Price developments were against the background of moderate domestic demand pressures, restrained growth in personal incomes and benign external price pressures.*

*1.5 Given projected low inflation in the medium term, the monetary policy stance was accommodative and the Bank Rate was reduced by 50 basis points to 5.5 percent in August 2016 to support economic activity; it was maintained at this level at the December 2016 meeting. The Bank also implemented an upward 0.38 percent annual rate of crawl of the nominal effective exchange rate (NEER) of the Pula effective January 2016, as inflation in Botswana was low compared to the average for the trading partner countries.[1] Bilaterally, the Pula depreciated by 7.5 percent against the South African rand, but appreciated by 8.9 percent against the SDR in the twelve months to December 2016.[2] The real effective exchange rate (REER) depreciated by 0.77 percent year on year to December 2016, given that the differential between the lower inflation in Botswana and average inflation in trading partner countries was larger than the upward rate of crawl.*

*1.6 Inflation is forecast to be within the 3 – 6 percent objective range in the medium term. Upside risks to the inflation outlook relate to any substantial upward adjustment in administered prices and government levies and/or taxes as well as any increase in international oil and food prices beyond current forecasts. However, there are downside risks associated with restrained global economic activity and the potential fall in commodity prices.*

## *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 a conducive financial environment 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.*

*2.2 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 account of prospects for economic growth and developments relating to stability of the financial system. To this end, in assessing the policy stance, the Bank*

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*1 The Pula basket weights for 2016 were 50 percent each for the South African rand and SDR.*

*2 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 are 41.73 percent, 30.93 percent, 10.92 percent, 8.33 percent and 8.09 percent.*

*factors in projections of real monetary conditions[3] in the context of other relevant domestic and international economic and financial developments, and their impact on the output gap[4] and, ultimately, on inflation. The policy framework also recognises the importance of communication to inform stakeholders in order to ensure transparency, market involvement and influence expectations. Commencing in 2017, the Bank will, after each meeting of the Monetary Policy Committee (MPC), through the Governor, deliver a statement at a press briefing to allow for interaction with the media and dissemination of the Bank's policy stance. There will also be public notification of the dates for the MPC meetings, initially for the subsequent half-year.*

## *3 IMPLEMENTATION OF MONETARY POLICY AND RELATED ECONOMIC DEVELOPMENTS IN 2016*

### *(a) External Developments*

*3.1 At the global level, monetary policy was implemented in the context of uneven economic performance across countries and regions. Policymakers continued to focus on the need to achieve sustainable economic growth through facilitating access to finance at a lower cost. Monetary policy was predominantly accommodative in the advanced economies, with low levels of interest rates and liquidity support to the financial sector. Thus, relevant policy interest rates moved further into the negative region in the euro area, while negative interest rates were also adopted by the Bank of Japan. Quantitative easing programmes were expanded in the euro area and Japan to enhance the monetary policy easing measures. The Bank of England cut interest rates by 25 basis points and announced further quantitative easing in August 2016 in a bid to offset the expected fallout from the referendum decision of the UK to leave the European Union. In the United States of America (USA), the Federal Funds Rate target range was increased by 25 basis points to 0.5 – 0.75 percent in December 2016, but remains comparatively low and accommodative. The direction of policy changes was mixed in the emerging market economies, as some central banks eased monetary policy to boost economic activity, while others raised interest rates to restrain inflationary pressures. The policy rate was increased by 75 basis points to 7 percent in South Africa during 2016 in order to anchor inflation expectations around the target range.*

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*3 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.*

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

3.2 *GDP growth in the advanced countries was weaker in 2016 than in 2015, but in the context of improving demand, accommodative financing conditions and improving labour market conditions. It is expected that these positive factors and additional fiscal stimulus in the USA will result in stronger economic activity in advanced countries in 2017. Economic performance was more diverse in the emerging market economies in 2016. Output growth was strong in emerging Asia, supported by policy stimulus, while activity was weaker in Latin American countries. Moreover, tighter external financing conditions, subdued demand and the adverse impact of lower commodity export prices constrained growth in some emerging market economies. Nonetheless, it is expected that economic activity will improve for these countries in 2017 as the modest slowdown of growth in China is offset by faster expansion in India and stabilising economic conditions in the larger economies, including Brazil and Russia, which are both expected to emerge from recession. Overall, global GDP growth is forecast at 3.4 percent in 2017, higher than the estimated 3.1 percent in 2016 (Table 1).*

***Table 1: Real GDP Growth Rates (Percent)***

| | Estimate | | Projections | |
|---|---|---|---|---|
| | **2015** | **2016** | **2017** | **2018** |
| **Global** | **3.2** | **3.1** | **3.4** | **3.6** |
| **Advanced economies** | **2.1** | **1.6** | **1.9** | **2.0** |
| United States of America | 2.6 | 1.6 | 2.3 | 2.5 |
| Euro Area | 2.0 | 1.7 | 1.6 | 1.6 |
| United Kingdom | 2.2 | 2.0 | 1.5 | 1.4 |
| Japan | 1.2 | 0.9 | 0.8 | 0.5 |
| **Emerging market and developing economies** | **4.1** | **4.1** | **4.5** | **4.8** |
| China | 6.9 | 6.7 | 6.5 | 6.0 |
| Brazil | -3.8 | -3.5 | 0.2 | 1.5 |
| India | 7.6 | 7.6 | 7.6 | 7.6 |
| Russia | -3.7 | -0.6 | 1.1 | 1.2 |
| South Africa | 1.3 | 0.3 | 0.8 | 1.6 |
| **Botswana** | **-0.3** | **2.9** | **4.2** | **4.1** |

*Source: International Monetary Fund, January 2017 World Economic Outlook Update, 2017/18 Budget Speech and 2017/18 Budget Strategy Paper, Botswana.*

3.3 *Global inflation remained low, increasing slightly from 2.8 percent in 2015 to 2.9 percent in 2016, mainly reflecting low commodity (including oil) prices, subdued global demand and persistent excess capacity in the major economies. International oil prices rebounded from an average low of USD 30 per barrel in January 2016 to above USD50 per barrel in December (Chart 1).[5] The recovery in oil prices was supported by the progress made towards cooperation on limiting production by major producers. Similarly, international food prices increased by 12*

5 *The rebound in oil prices in December 2016 followed the agreement by OPEC to reduce output and excess supply, effective January 2017, which had weighed on prices for the past two years.*

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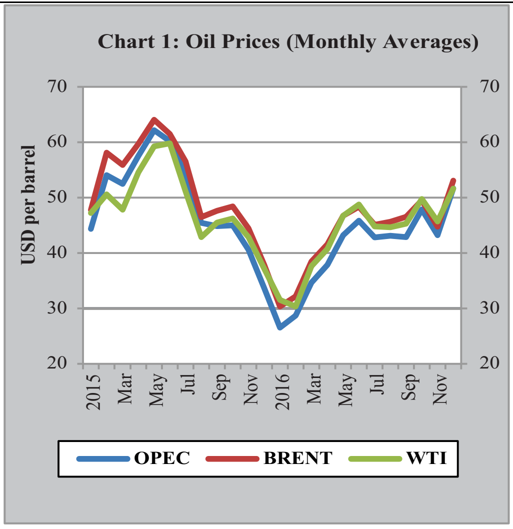
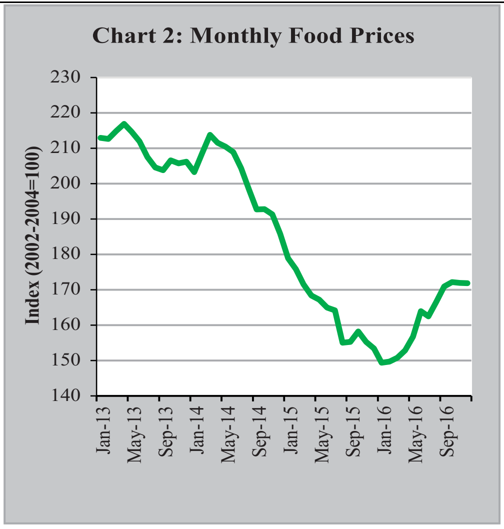
*percent in 2016 compared to a decline of 17.5 percent in 2015 (Chart 2). Generally, international oil and food prices presented a low risk to domestic inflation in 2016.*




*Source: OPEC and US Energy Information Administration.*




*Source: Food and Agricultural Organisation.*

3.4 *For Botswana's trading partner countries, trade-weighted average inflation increased from 2.8 percent in December 2015 to 4.2 percent in December 2016.*[6] *Inflation increased from 0.7 percent in December 2015 to 1.7 percent in December 2016 in the SDR countries*[7]*, while for South Africa, inflation increased from 5.2 percent to 6.8 percent in the same period (Chart 3).*[8]

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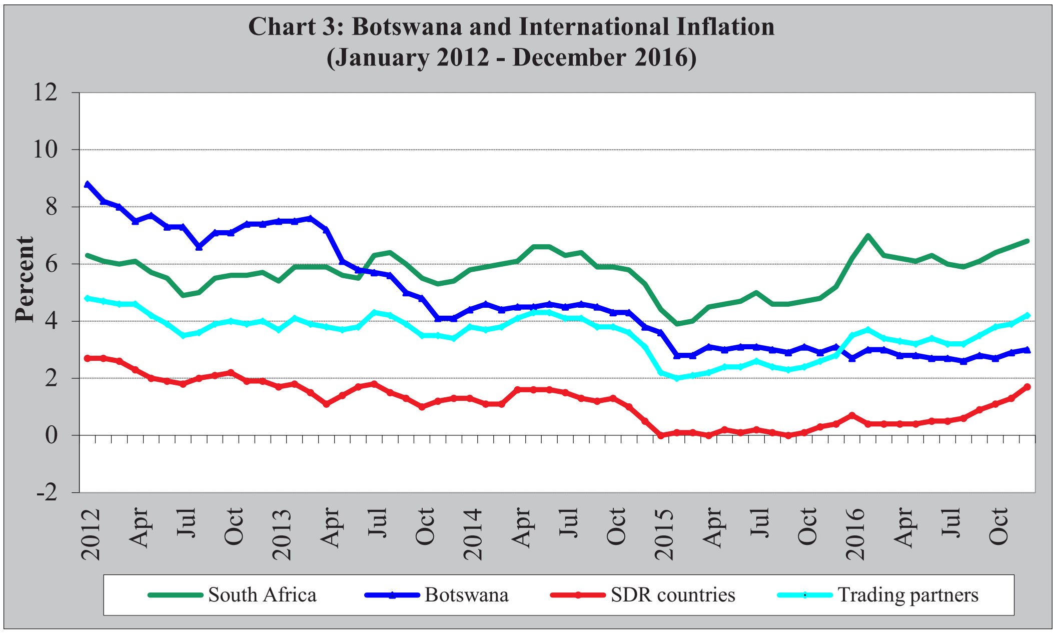
6 *The trade-weighted average inflation comprises South Africa's headline inflation and average SDR countries' inflation.*

7 *Inflation was below target in all the SDR countries.*

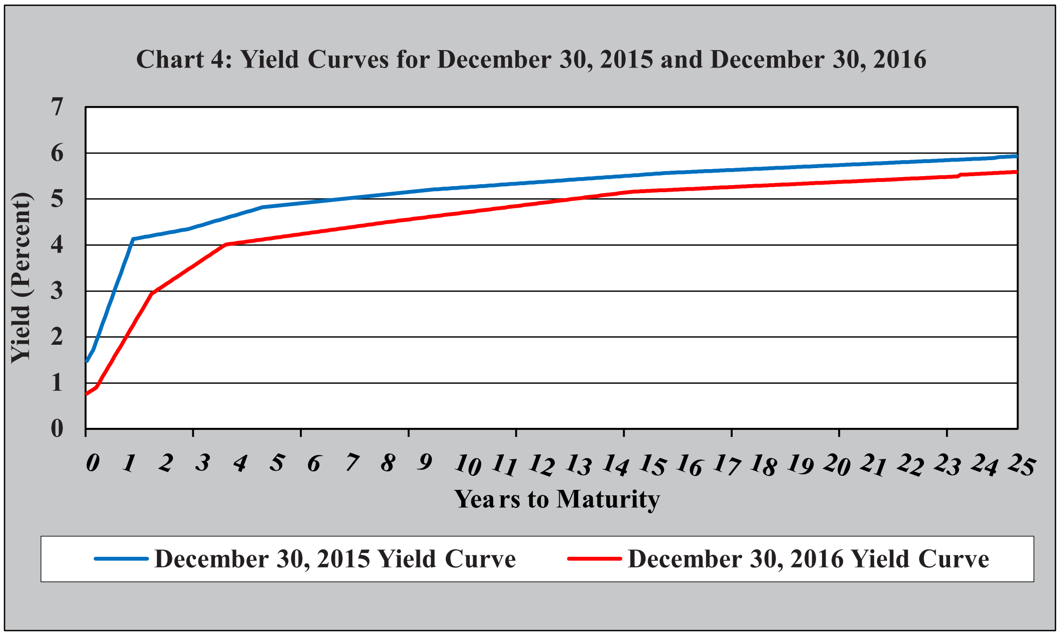
8 *Inflation breached the upper end of the country's medium-term target range of 3 – 6 percent for most of 2016.*



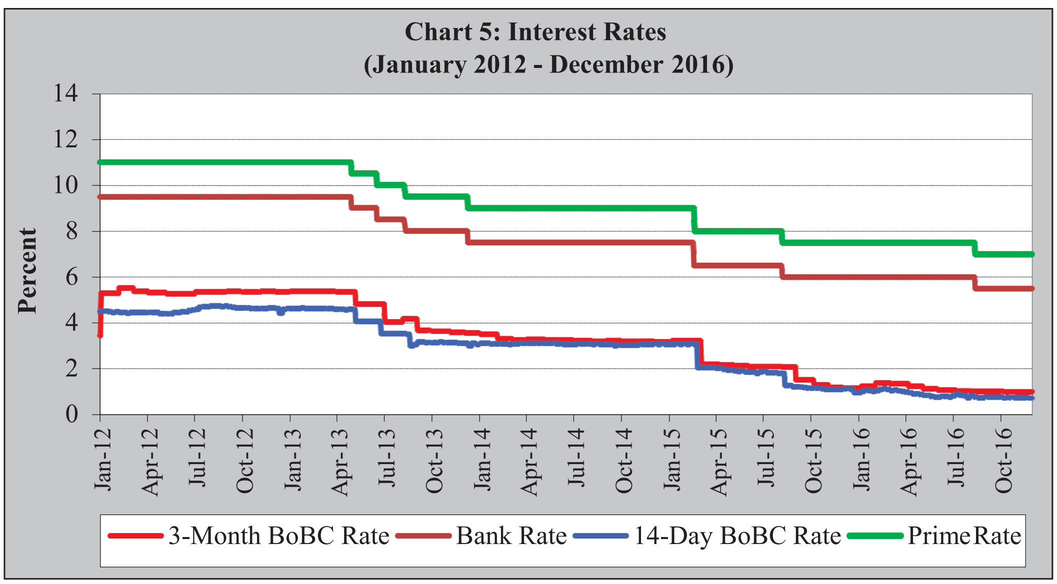

*Source: Statistics Botswana.*

### *(b) Monetary Policy Implementation in Botswana*

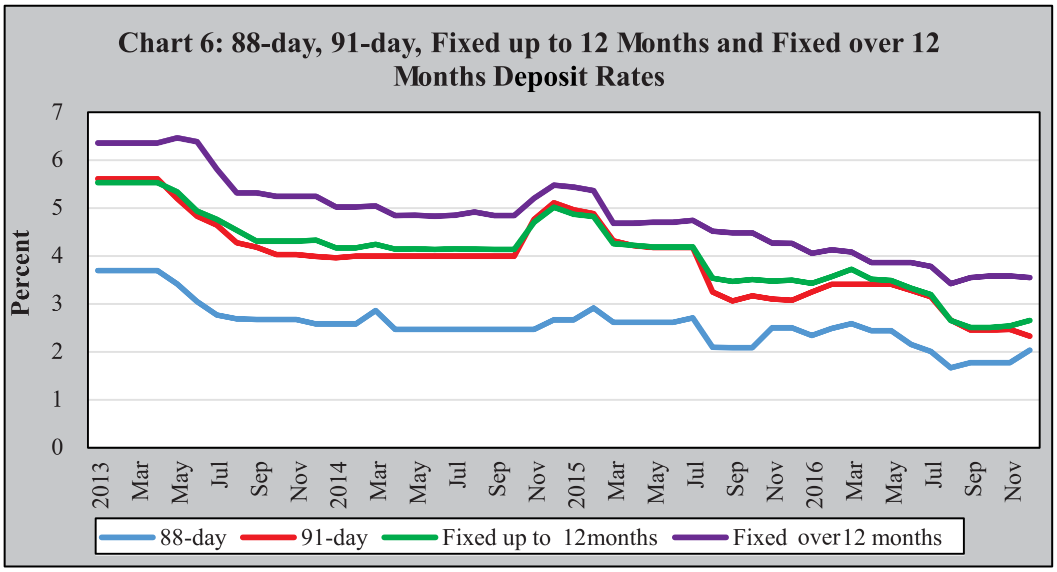
*3.5 Domestically, monetary policy was conducted against the backdrop of below-trend economic activity (a non-inflationary output gap) and a positive medium-term inflation outlook. Inflation was restrained by slow growth in personal incomes, moderate increase in credit and the resultant subdued domestic demand. Moreover, foreign inflation was low, on average, with benign pressure on domestic prices. These developments provided scope for an accommodative monetary policy in support of stronger output growth. Thus, the Bank Rate was reduced by 50 basis points in August 2016 to 5.5 percent, resulting in the commercial banks' prime lending rate declining from 7.5 percent to 7 percent (Chart 5). Deposit interest rates also fell in line with the reduction in the Bank Rate (Chart 6). As at 30 December 2016, bond yields ranged from 2.4 percent to 5.4 percent for the shortest and longest maturities, respectively.*




*Source: Statistics Botswana.*




*Source: Bank of Botswana.*




*Source: Commercial banks.*

3.6 *Monetary policy implementation entailed the use of Bank of Botswana Certificates (BoBCs) to absorb excess liquidity*[9] *in order to maintain interest rates that are consistent with the monetary policy stance; while reverse repurchase agreements (repos) were used to absorb excess liquidity between weekly auctions of BoBCs. To encourage productive commercial bank lending and market efficiency, as well as alleviate the cost of liquidity absorption, the Bank conducted monetary operations with a view to limiting BoBCs issuance and the use of repos, although this was balanced against the need to keep money market interest rates aligned with the monetary policy stance. As a result, outstanding BoBCs amounted to P7.9 billion in December 2016, a decrease from P8.2 billion in December 2015.*

3.7 *Money market interest rates decreased in 2016, largely reflecting competitive bidding by banks for a restricted allocation of BoBCs. The 14-day BoBC yield fell from 0.97 percent in December 2015 to 0.84 percent in December 2016, while the 3-month BoBC yield decreased from 1.17 percent to 1.01 percent in the same period.*[10] *Consequent to the larger decline in the nominal interest rate than the fall in inflation between December 2015 and December 2016, the real 3-month BoBC yield decreased from -1.87 percent to -1.93 percent in the same period (Chart 7).*[11]

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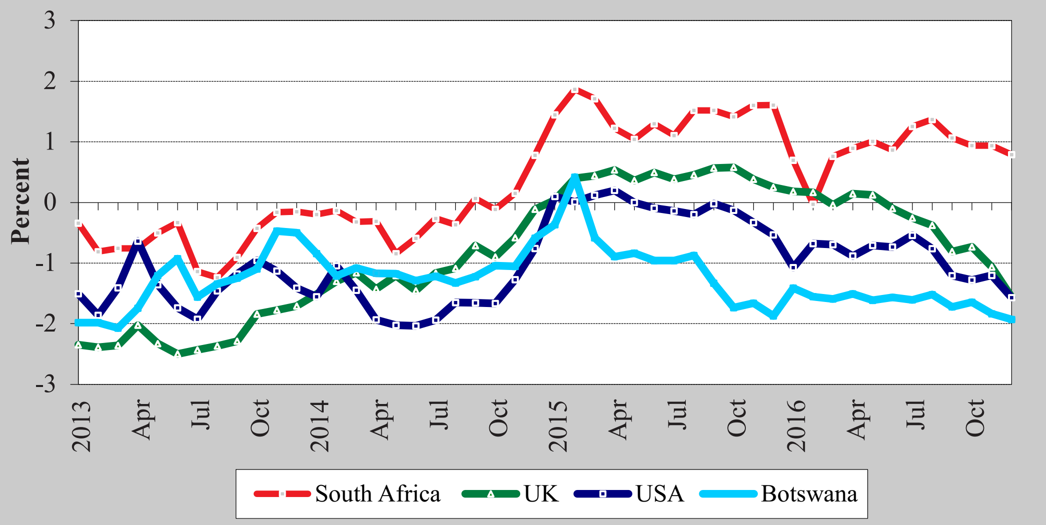
9 *Excess liquidity is money balances in excess of what is needed by the commercial banks for investment and daily flows, with no credit extension obligation and, hence, can be invested temporarily. Importantly, each commercial bank holds a specific level of excess liquidity that reflects its asset-liability management policy.*

10 *The 14-day and 3-month BoBC yields quoted here are stop-out yields. A stop-out yield is the yield that corresponds to the cut-off price in the allocation of accepted bids at the auction of BoBCs.*

11 *The real 14-day BoBC rate decreased from -2.07 percent in December 2015 to -2.10 percent in December 2016. Internationally, the real 3-month money market interest rates were 0.79 percent, -1.56 percent, -1.57 percent and -2.06 percent in December 2016 for South Africa, UK, USA and the euro area, respectively.*

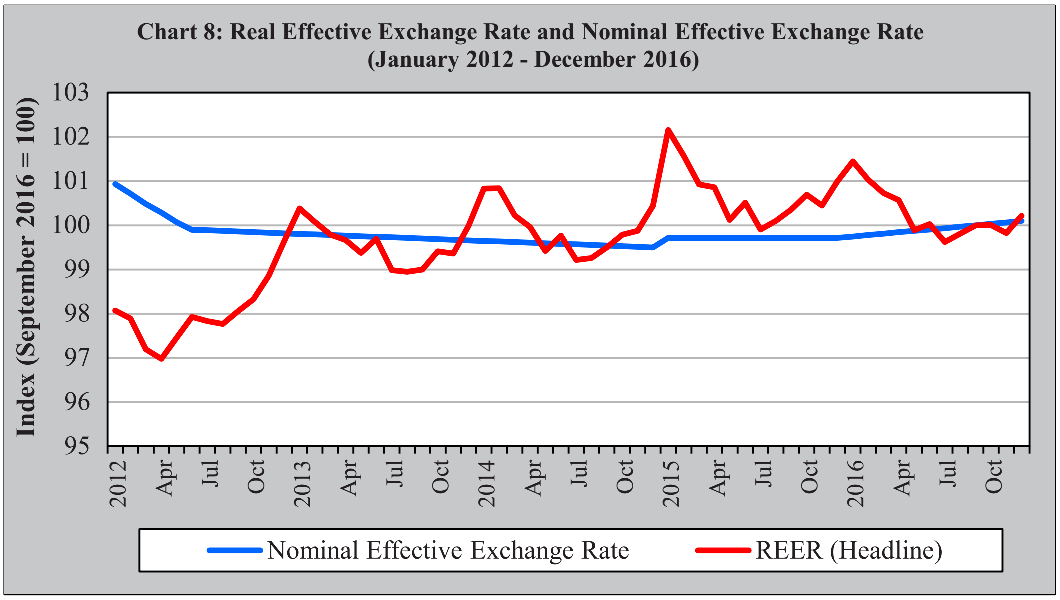
**Chart 7: Real Interest Rates: International Comparisons for 3-Month Money Market Instruments (January 2013 - December 2016)**




*Source: Bank of Botswana.*

### *(c) Implementation of Exchange Rate Policy*

*3.8 Implementation of the exchange rate policy was in line with the objective of maintaining a stable inflation adjusted trade-weighted exchange rate of the Pula (real effective exchange rate – REER). In this regard, the Bank implemented a 0.38 percent upward rate of crawl of the NEER during 2016 as the projected domestic inflation was close to the lower end of the medium-term inflation objective and, therefore, lower than the expected average trading partner countries' inflation (Box 1 in the appendix provides an explanation of the exchange rate policy). Consequently, the trade-weighted NEER of the Pula appreciated by 0.38 percent in the twelve months to December 2016. Meanwhile, the REER depreciated by 0.77 percent in the twelve months to December 2016 (Chart 8) as the difference between inflation in Botswana and higher inflation in the trading partner countries was larger than the upward rate of crawl.*




*Source: Bank of Botswana.*

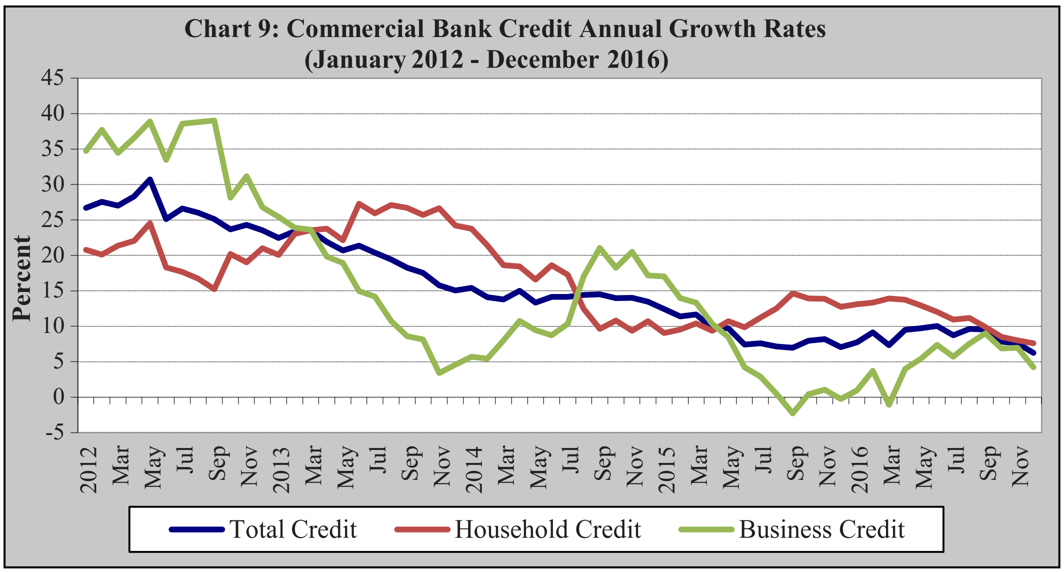
*Note: The indices have been revised due to the rebasing of the Consumer Price Index (CPI) to September 2016.*

### *(d) Government Expenditure and Credit Growth*

3.9 *Monetary policy was conducted within a fiscal environment that was supportive of domestic economic activity, with 9.7 percent annual growth in government expenditure (twelve months to December 2016), slightly higher than 9.6 percent growth in the twelve-month period ending in December 2015. Development and recurrent expenditure increased by 20.3 percent and 6.1 percent, respectively, in the same period. The growth in recurrent expenditure included a 3 percent increase in salaries for civil servants, the impact on aggregate demand of which was not significant enough to generate notable inflationary pressures.*

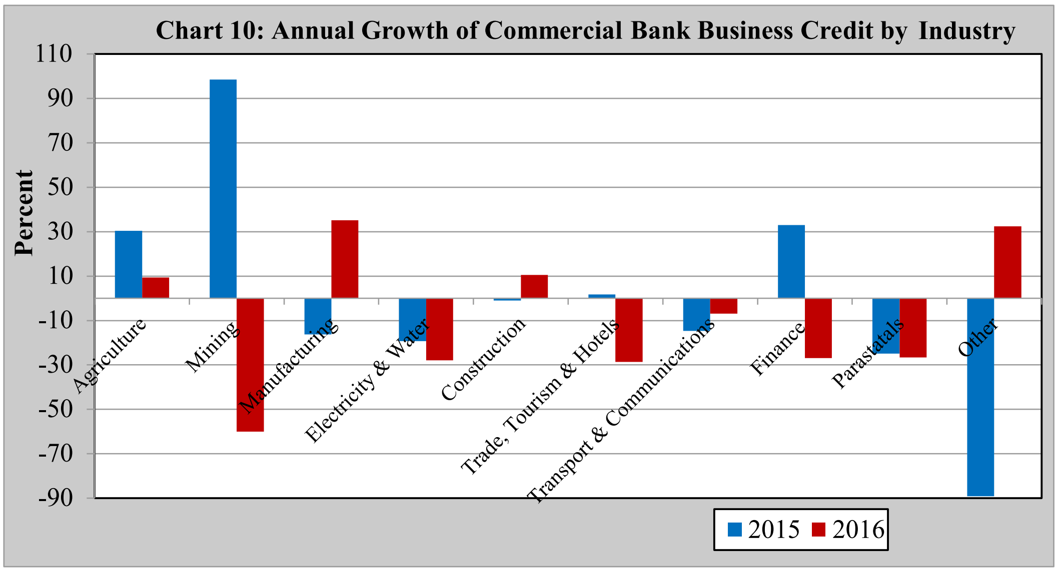
3.10 *Despite an accommodative monetary policy stance, annual growth in commercial bank credit decreased from 7.1 percent in December 2015 to 6.2 percent in December 2016, against a background of subdued economic activity and restrained growth in personal incomes. The slowdown in annual credit expansion was mostly associated with the decrease in growth in lending to households from 12.8 percent in December 2015 to 7.6 percent in December 2016, largely reflecting the effect of restrained growth in personal incomes. The lower rate of increase in lending to households was mostly due to a slowdown in the yearly rate of expansion in unsecured loans to this sector from 15.5 percent to 8.3 percent in the same period. Meanwhile, the annual growth in mortgage lending to households also slowed from 7.2 percent to 6.3 percent in the same period. The share of mortgages in total bank households' credit decreased from 28.8 percent in December 2015 to 28.4 percent in December 2016. The lower growth of mortgage lending appears to be consistent with the weaker residential property market in 2016.*

3.11 *For businesses, year-on-year growth in lending accelerated from a contraction of 0.3 percent in December 2015 to growth of 4.2 percent in December 2016 (Chart 9). Even then, while lending to manufacturing, "other", and construction expanded, credit growth to agriculture decelerated, while it was negative for other sectors (Charts 10). Notably, there was a significant decline in credit for the mining sector, mainly as a result of the BCL group loan repayment in December 2016.*[12] *Despite the modest credit growth, the upward trend in the credit-to-GDP ratio was maintained, indicating an increasing role of credit in support of growth in economic activity (Chart 11 and Table 2). In general, the non-inflationary increase in credit for consumption as well as business investment and operations is positive for the economy. In the circumstance, accommodative monetary policy stance and restricted liquidity absorption through BoBCs was appropriate.*

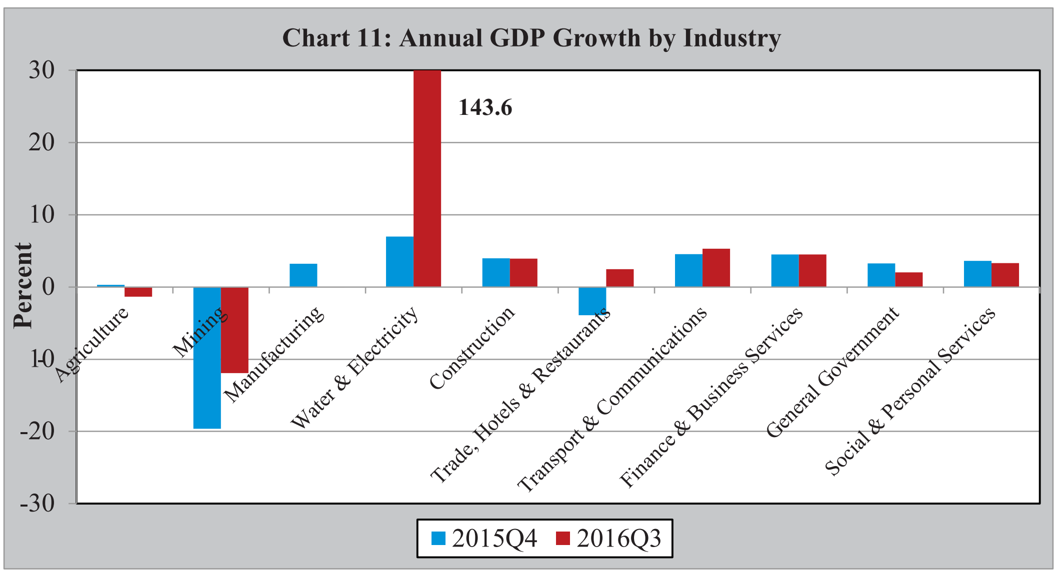



*Source: Commercial banks.*

12 *As at December 2016, the exposure of financial institutions to the BCL group and employees was estimated at approximately P110 million and P400 million, respectively, which is mitigated to an extent by guarantees and collateral. This was equivalent to 0.8 percent of gross loans.*




*Source: Commercial banks.*




*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 2: Commercial Bank Credit-to-GDP Ratio (Percent)***

| | 2004 | 2014 | 2015 | 2016Q3[4] |
|---|---|---|---|---|
| **Total Commercial Bank Credit[1]** | **20.1** | **30.9** | **33.1** | **42.1** |
| **Business** | **8.5** | **13.5** | **13.5** | **17.3** |
| Parastatals | 1.0 | 1.7 | 1.3 | 1.7 |
| Agriculture | 0.3 | 0.5 | 0.7 | 1.0 |
| Mining | 0.1 | 0.3 | 0.5 | 0.3 |
| Manufacturing | 0.8 | 2.0 | 1.7 | 2.6 |
| Construction | 0.6 | 0.6 | 0.6 | 0.8 |
| Trade | 1.1 | 4.1 | 4.2 | 4.0 |
| Transport and Communications | 0.7 | 0.6 | 0.5 | 0.5 |
| Finance and Business Services | 3.1 | 0.9 | 1.2 | 3.0 |
| Real Estate[2] | | 2.4 | 2.4 | 3.0 |
| **Households** | **11.6** | **17.4** | **19.6** | **24.8** |
| Retail Credit[3] | 9.1 | 12.1 | 14.0 | 17.7 |
| Mortgage | 2.5 | 5.3 | 5.6 | 7.1 |

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

*Note:*

1. *Although not shown in the table, the ratio of credit-to-GDP for the following subsectors are included in the business credit-to-GDP; electricity and water, other and non-resident business.*
2. *In 2004, 'real estate' was a constituent of 'other'.*
3. *Includes motor vehicle, personal and credit card loans.*
4. *The credit-to-GDP ratio for 2016Q3 is not consistent with the yearly ratios, as credit is cumulated up to September 2016, while GDP is for the three quarters of the same year. As a result, the credit-to-GDP ratio is relatively inflated for this period and needs to be interpreted with caution.*

### *(e) Financial Stability Indicators*

3.12 *Developments with respect to household credit are in line with the slower growth in incomes and augur well for maintenance of financial stability. In particular, the moderation in mortgage credit growth in the context of the weaker property market moderates potential risks in this area. Furthermore, default rates are relatively low and stable (the ratio of non-performing loans to total credit was 4.4 percent at the end of December 2016), while there is sufficient provisioning by banks. Overall, the capital, asset quality, liquidity and profitability levels that meet prudential requirements for banks indicate a generally stable financial system (Table 3). In addition, the modest growth in credit is in the context of projected positive non-mining GDP growth.*

*Table 3: Selected Performance Indicators of the Banking Sector*

| | Sep 2015 | Dec 2015 | Sep 2016 | Dec 2016 |
|---|---|---|---|---|
| ***Capital Adequacy (Percent)*** | | | | |
| *Core Capital to Total Capital*[1] | 67.5 | 70.2 | 69.3 | 68.7 |
| *Core Capital to Risk-Weighted Assets*[2] | 14.2 | 14.0 | 12.5 | 13.2 |
| *Unimpaired Capital to Risk-Weighted Assets*[3] | 21.1 | 20.0 | 18.0 | 19.2 |
| ***Asset Quality (Percent)*** | | | | |
| *Non-performing loans (NPLs) to Gross Loans* | 3.6 | 3.9 | 4.8 | 4.4 |
| *NPLs Net of Specific Provisions to Unimpaired Capital* | 14.2 | 9.0 | 14.3 | 13.9 |
| *Specific Provisions to NPLs* | 42.2 | 54.7 | 44.5 | 57.1 |
| ***Liquidity (Percent)*** | | | | |
| *Liquid Assets to Deposits (Liquidity Ratio)*[4] | 25.0 | 19.7 | 18.2 | 21.6 |
| *Advances to Deposits* | 76.6 | 80.7 | 84.5 | 82.2 |
| ***Profitability/Efficiency (Percent)*** | | | | |
| *Return on Average Assets* | 1.9 | 1.9 | 2.4 | 3.1 |
| *Return on Equity* | 17.6 | 18.2 | 21.6 | 27.2 |
| *Cost to Income* | 62.6 | 61.1 | 57.8 | 57.0 |

*Source: Bank of Botswana.*

*Notes:*
1. *Prudential lower limit is 50 percent.*
2. *Prudential lower limit is 7.5 percent (prior to January 2016, it was 4 percent).*
3. *Prudential lower limit is 15 percent.*
4. *Prudential lower limit is 10 percent.*

3.13 *Household loans, with a share of 60.1 percent at the end of December 2016, continue to dominate commercial bank credit. It is also observed that the concentration of household credit is in unsecured lending (66.1 percent). However, the risk to financial stability of this lending composition is moderated by the extent to which unsecured credit is diversified (relatively small amounts spread across many borrowers of differing risk profiles). Furthermore, the bulk of the household credit is to salaried individuals, which enables proper credit evaluation using ascertained income as the basis for determining ability to repay.*[13] *In addition, credit risk is lowered where loans are protected by credit life insurance. Overall, current levels of credit continue to be supportive of economic activity and bode well for durable stability of the financial system.*

3.14 *An enduring challenge for commercial banks is the concentration of business deposits in their funding structure (73.4 percent of total deposits, mostly wholesale bulk deposits), part of which are for other financial institutions, potentially reflecting an imbalance in the market and the accompanying risk. Notably, there was a significant deceleration in annual growth of household deposits from a growth of 16.8 percent in December 2015 to a contraction of 3.6 percent in December 2016. This could reflect a potential financial strain on households arising from the sluggish growth in incomes. Similarly, annual growth in business deposits decreased significantly from 16.2 percent in December 2015 to 7.2 percent in December 2016.*

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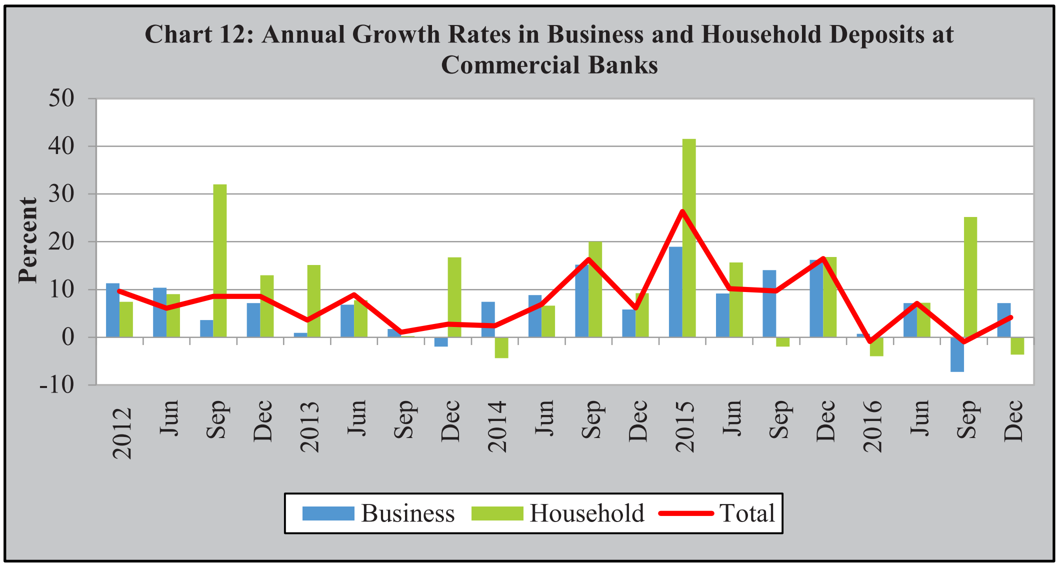
13 *There is, nevertheless, some risk relating to individuals borrowing from multiple institutions and sources, which could lead to excessive debt burdens, due to the absence of credit information sharing.*

*This resulted in a substantial decrease in the yearly growth in total deposits at commercial banks from 16.4 percent to 4.1 percent in the same period (Chart 12). In the context of the higher increase in bank lending than growth in bank deposits, the intermediation ratio increased from 80.7 percent in December 2015 to 82.2 percent in December 2016.*[14]




*Source: Commercial Banks.*

### *(f) Output and Price Developments*

3.15 *In Botswana, real GDP grew by an estimated 0.9 percent in the twelve months to September 2016 compared to a revised contraction of 0.1 percent in the corresponding period ending in September 2015. A contraction of 11.9 percent in mining output in the same period (11.8 percent in 2015) weighed down on overall GDP growth. The non-mining sectors expanded moderately by 3 percent, higher than growth of 2.1 percent in the twelve months to September 2015 (Chart 13).*

14 *The intermediation ratio is defined as the ratio of total loans to total deposits, thus indicating the proportion of deposits that is intermediated into funding loans.*

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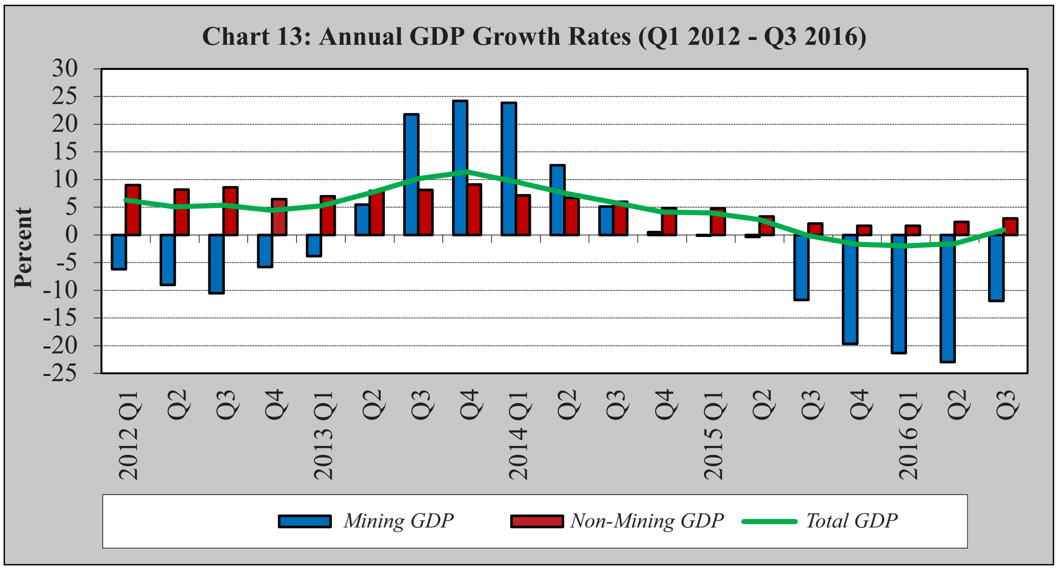


*Source: Statistics Botswana and Bank of Botswana calculations.*

3.16 *The weakness in economic activity, together with modest wage growth (and the associated low demand pressures), resulted in dampened inflationary pressures during 2016. The impact of external factors on domestic prices was also benign due to low average inflation in the trading partner countries. The relative strength of the Pula exchange rate against the rand and increasing domestic competitiveness moderated the impact of higher inflation in South Africa on domestic prices. Therefore, domestic inflation was modest and stable in 2016 and, in the main, below the lower end of the Bank's 3 – 6 percent objective range.*[15]

3.17 *Inflation fell slightly from 3.1 percent in December 2015 to 3 percent in December 2016 (Chart 14).*[16] *The rate of increase in prices was lower for most categories of goods and services. In particular, fuel prices fell by 3.3 percent in the year to December 2016*[17] *following a 15.7 percent decrease in 2015. However, food price inflation increased from 0.7 percent in December 2015 to 3.9 percent in December 2016 (Chart 15). On average, the net effect of adjustments to administered prices was a reduction in inflation by approximately 0.11 percentage points in 2016 compared to a reduction of 0.71 percentage points in 2015. Regarding core inflation measures, the 16 percent trimmed mean inflation decreased from 3.2 percent in December 2015 to 2.5 percent in December 2016, while inflation excluding*

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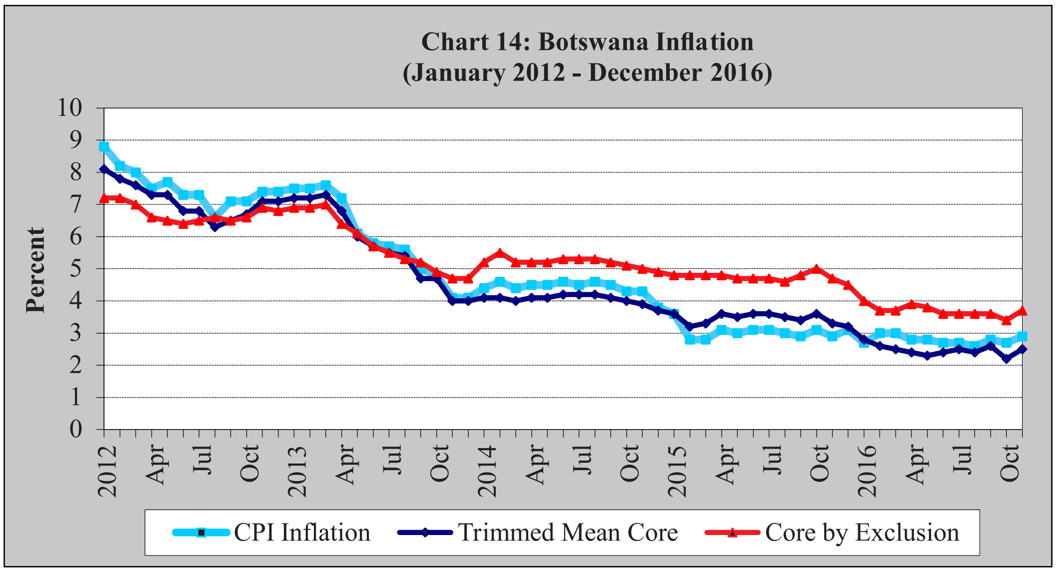
15 *Inflation was in the objective range only in February, March and December, at 3 percent in each month and was lower than 3 percent in the other months (including a record low of 2.6 percent in August 2016).*

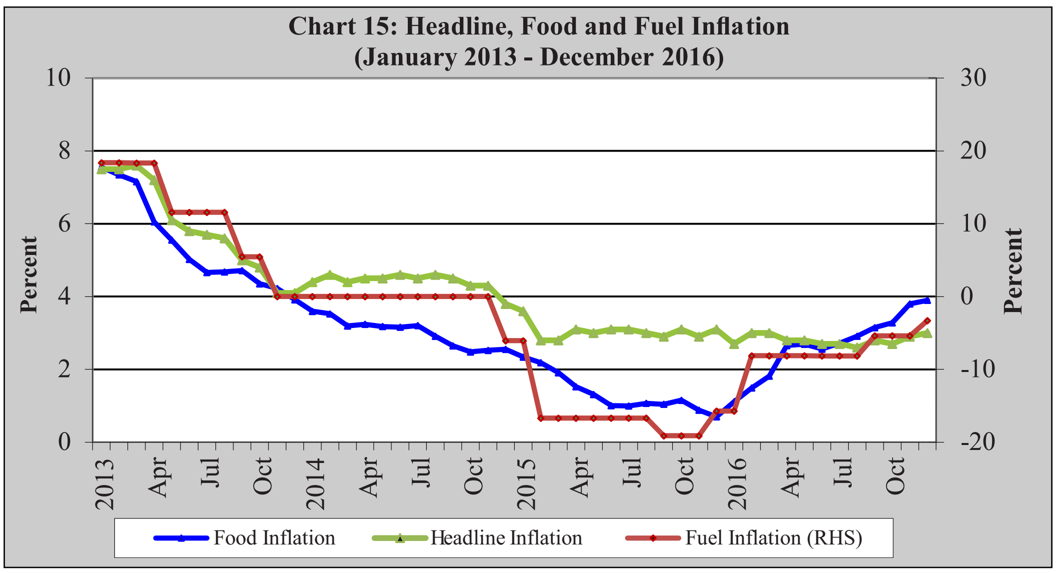
16 *Using the results of the 2009/10 Botswana Core Welfare Indicators Survey, the Consumer Price Index (CPI) was rebased from September 2006 to September 2016. The CPI rebasing also entailed an increase in the number of basket items from 384 to 393 and adjustments of commodity group weights, while categorisation into 51 sections and 12 commodity groups was maintained.*

17 *This was in the context of a reduction in fuel prices in February 2016.*

*administered prices decreased from 4.5 percent to 3.7 percent in the same period.*




*Source: Statistics Botswana.*




*Source: Statistics Botswana.*

## *4. INFLATION OUTLOOK*

*4.1 The global GDP growth forecast of 3.4 percent for 2017 exceeds the estimated 3.1 percent for 2016. The projected improvement in global economic expansion is premised on expected stronger growth in some emerging market economies, including a gradual recovery from recession of Brazil and Russia. It is also anticipated that stabilisation and successful rebalancing by China from investment and industry-led growth to emphasis on consumption and services will be positive for economic performance of the emerging market economies. In advanced economies, it is projected that growth will gradually gain momentum, supported by* *relatively low oil prices, accommodative financing conditions, improving labour markets and possible implementation of fiscal policy stimulus in the USA. However, the subdued commodity prices, monetary policy tightening in the USA, possible protectionist trade policies, geopolitical tensions and persistence of tight financing conditions in some key markets, continue to present downside risks to global economic performance.*

4.2 *It is anticipated that global inflationary pressures will be restrained, largely reflecting subdued commodity prices (expected to recover only partially) and sluggish global demand. However, global inflation is forecast to increase from 2.9 percent in 2016 to 3.3 percent in 2017. Inflation increased in several advanced economies in 2016, and it is projected to increase further in 2017 as the effect of the earlier decrease in energy prices dissipates. In emerging market economies, inflation is expected to moderate as the effect of previous currency depreciation tapers off in 2017. In this environment, it is anticipated that monetary policy will remain accommodative in most economies, complemented by measures aimed at facilitating financial intermediation and fostering resilience of the financial sector to support economic activity.*

4.3 *In the SDR countries, inflation is forecast to be 2 percent in 2017, higher than1.7 percent in 2016, while for South Africa, headline inflation is expected to decrease from an average 6.3 percent in 2016 to 5.8 percent in 2017.*[18] *Thus, average inflation for trading partner countries is forecast to be in the range of 3 – 4.2 percent. Given that inflation in Botswana is projected to be around the lower end of the medium-term objective range of 3 – 6 percent, hence below the forecast average inflation (mid-point) for trading partner countries, the NEER will crawl upwards by 0.26 percent in 2017, lower than the upward crawl rate of 0.38 percent for 2016. In addition, to reflect changes in the trade pattern, the Pula basket weights have been adjusted to 45 percent for the South African rand and 55 percent for the SDR (previously 50 percent each). Against this background, it is anticipated that the impact of external price developments, through imported inflation and changes in the exchange rate, on domestic inflation will be modest.*

4.4 *As indicated in the 2017/18 Budget Speech, domestic output growth is forecast to be 4.2 percent in 2017, higher than the projected 2.9 percent for 2016. However, domestic non-mining output will be below trend going forward (Chart 16), influenced mainly by the restrained growth in personal incomes, lower increase in government expenditure, lingering uncertainty about the supply of electricity and water, sluggish recovery of the mining sector (dampened further by the closure of BCL and Tati Nickel mines in October 2016), as well as restrained economic activity in major trading partners. The Bank's September 2016 Business Expectations Survey (BES) indicates improvement in business confidence regarding economic performance compared to the March 2016 BES. Looking ahead, there is an increase in optimism, despite uncertainty surrounding demand for commodities in the global*

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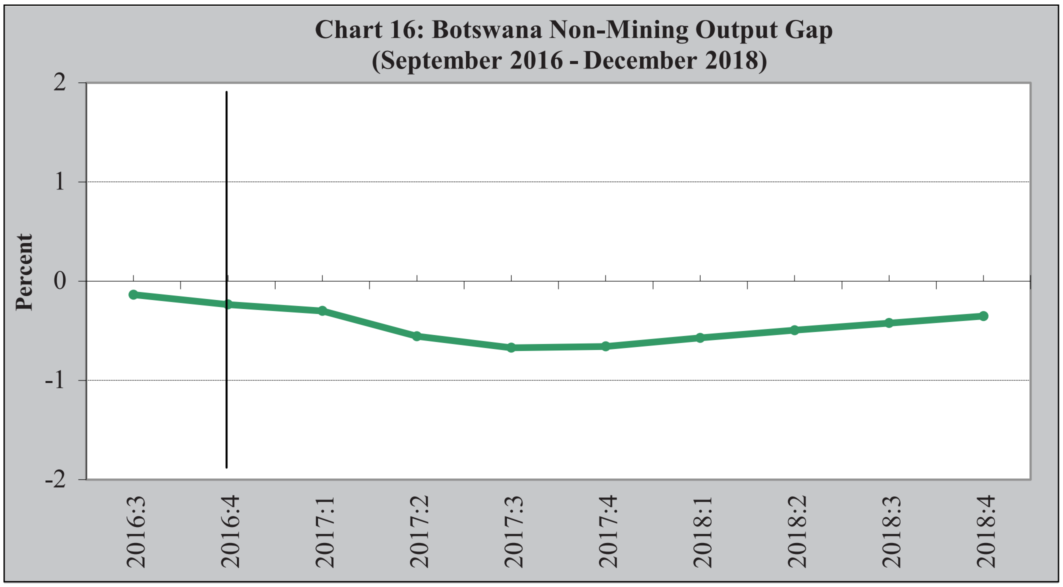
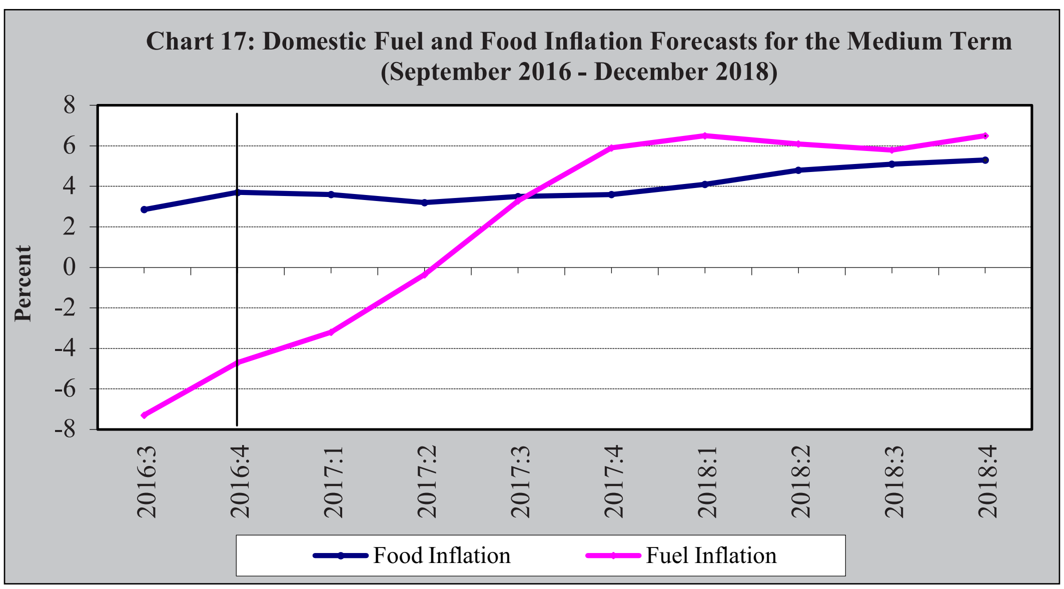
18 *These forecasts are obtained from Thompson Reuters. At 6.2 percent, the South African Reserve Bank's forecast for average inflation for 2017 is slightly higher than that of Thompson Reuters.*

*market which continues to undermine business confidence.*

4.5 *For the 2017/18 fiscal year, total government expenditure is budgeted to increase by 6.5 percent, resulting in an anticipated budget deficit of P2.35 billion (1.43 percent of GDP), mainly owing to slowing increase in revenues. The budgeted growth in spending includes higher development expenditure to finance Economic Stimulus Programme projects. 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.*

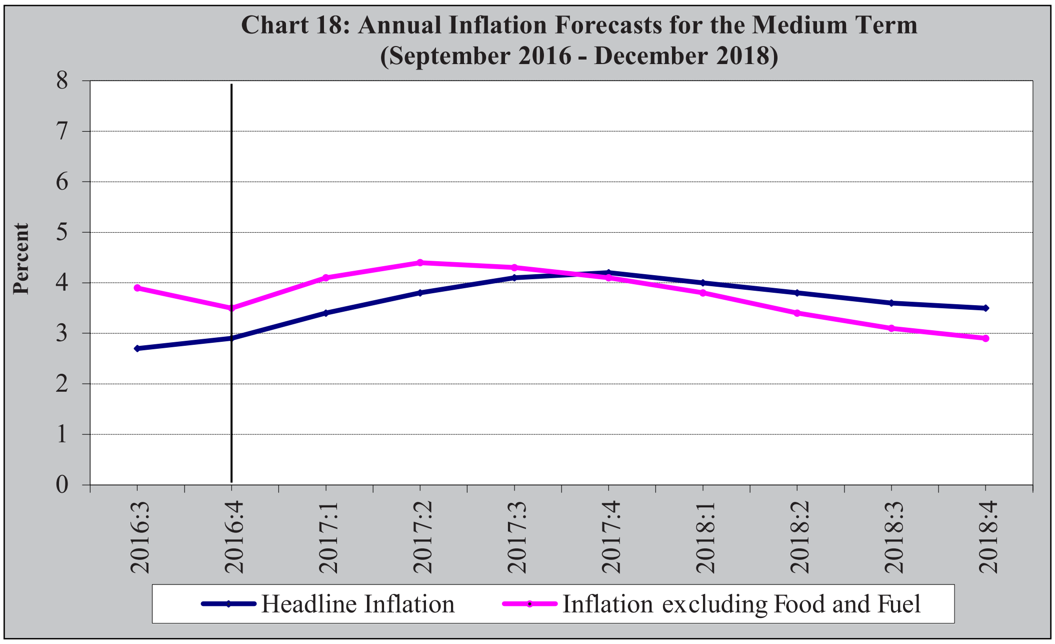



*Source: Bank of Botswana.*




*Source: Bank of Botswana.*

4.6 *It is projected that growth in personal incomes will continue to be restrained, contributing to modest overall domestic demand, with a dampening effect on inflation in the medium term. Given prospects for benign external price developments, it is projected that inflation will remain within the 3 – 6 percent objective range in the medium term (Chart 18). The forecast incorporates the effect of the expected increase in fuel prices as well as water and electricity tariffs.*[19] *Any substantial upward adjustment in administered prices and government levies and/or taxes as well as any increase in international food and oil prices beyond current forecasts present upside risks to the inflation outlook (Chart 18). However, there are downside risks associated with the restrained global economic activity, technological progress and falling commodity prices.*




*Source: Bank of Botswana.*

## *5. 2017 MONETARY POLICY STANCE*

5.1 *An evaluation of determinants of inflation and financial stability suggests continuance of low inflation into the medium term, within a robust and supportive financial system. Despite slowing down, commercial bank credit growth is broadly in line with the pace of increase in nominal GDP (5.8 percent in third quarter of 2016) and continues to support economic activity. The current levels of growth in credit to both businesses and households are considered to be sustainable. Thus, the current and prospective developments (positive inflation outlook and a stable financial environment) augur well for accommodative monetary policy that supports productive lending to businesses and households. The Bank will continue*

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*19 The expected increase in fuel prices is estimated to directly contribute 0.64 percentage points to inflation in the first quarter of 2017, while the upward adjustment in water and electricity tariffs is projected to contribute 0.39 percentage points to inflation in the second quarter of 2017.*

*to respond appropriately to changes in banking system liquidity conditions through relevant instruments. In this context, the Bank encourages productive allocation of financial resources, while effectively managing banking system liquidity. In this regard, the Bank guides the determination of market interest rates that are consistent with the monetary policy stance, with respect to both the level and direction. The Bank also promotes effectiveness of the interbank market to address liquidity positions in individual banks.*

5.2 *In 2017, the Bank's implementation of the exchange rate policy will entail a 0.26 percent upward rate of crawl of the NEER to stabilise the REER, given that inflation is projected to be around the lower end of the medium-term objective range of 3 – 6 percent. 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 and appreciation of the rand would induce related capital outflows. However, short-term capital movements are constrained by relative illiquidity and the dearth of financial instruments in the Botswana market and uncertainty associated with a volatile rand exchange rate and higher inflation. Moreover, Botswana represents a stable macroeconomic environment for inward investment by expanding regional businesses.*

## *6. CONCLUSION*

6.1 *Domestic inflation was mostly below the lower end of the Bank's objective range of 3 – 6 percent in 2016 against the background of benign domestic demand pressures, modest wage growth and favourable foreign price developments. Global GDP growth is projected to be higher in 2017 than in 2016, while global inflation is forecast to increase as oil prices rise modestly and output gaps steadily contract.*

6.2 *It is projected that inflation 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.*

6.3 *Henceforth, there will be a press briefing at the conclusion of each MPC meeting, while dates for the ensuing half-year period will be announced in advance.*

## *APPENDIX*

### *Box 1: Botswana's Exchange Rate Framework*

*The Current Exchange Rate Policy*

*Botswana's exchange rate policy is aimed at achieving competitiveness of local producers of tradeable goods and services in both international and domestic markets. By extension, therefore, the policy supports the national objective of economic diversification, together with the associated industrial development and employment creation objectives/initiatives. Therefore, the primary focus is on stability of the real effective exchange rate.*

*The Pula Basket*

*In the current exchange rate system, the exchange rate is determined on the basis of a peg of the Pula to a basket of currencies, the choice of which is guided by trade patterns and currencies used in international trade and payments. As a result, the Pula is pegged to a trade-weighted basket of currencies that comprise the South African rand and the Special Drawing Right (SDR), which is the unit of account for the International Monetary Fund. The SDR is a composite unit constituted by the US dollar, Euro, Japanese yen, British pound and the Chinese renminbi. Pegging to a basket of currencies rather than a single currency means that movements in the Pula exchange rate are not subject to an extreme influence of exceptional volatility of any single currency.*

*Current Exchange Rate Framework*

*An important goal of the exchange rate policy is stabilisation of the real effective exchange rate in relation to Botswana's main trading partners. In line with this objective, the authorities closely monitor the relative inflation performance between Botswana, South Africa and the SDR countries. In this regard, the crawling peg mechanism adopted in May 2005 allows for continuous adjustment (crawling) of the Pula exchange rate to correct for any misalignment (i.e., either overvaluation or undervaluation) of the exchange rate. The crawling arrangement is an improvement over the discrete adjustment (through either devaluation or revaluation) of the exchange rate that may be implemented unexpectedly. In the crawling peg framework, prospects for changes in competitiveness (i.e., inflation differentials between Botswana and trading partner countries) are projected and the exchange rate is set to adjust gradually to forestall the potential loss in price competitiveness. When the forecast inflation for Botswana is higher (lower) than the average forecast inflation of the trading partners, a downward (upward) crawl is implemented, and when they are equal (zero inflation differential) the rate of crawl is zero. A gradual upward adjustment of the annual rate of crawl, such as 0.26 percent for 2017, means that the exchange rate is adjusted daily in minuscule, fixed amounts, which accumulate to an annual change of 0.26 percent.*

*Alternative Exchange Rate Frameworks or Regimes*

*Broadly, there are two exchange rate frameworks (also, systems): the fixed and floating/flexible exchange rate systems. The exchange rate is the price of one currency expressed in another currency. In the fixed exchange rate framework, the exchange rate is fixed by government and managed through sale or purchase of foreign currency. The government retains the discretion to reduce the value of the domestic currency (devaluation) or increase its value (revaluation). When a policy of floating exchange rate is pursued, the exchange rate between the domestic and foreign currencies is determined purely by market forces of demand and supply. In this regime, the domestic currency can either appreciate (increase in value) or depreciate (decrease in value) depending on demand for and supply of the currency. Between the fixed and floating exchange rate systems lies various exchange rate arrangements which combine, in varying degrees, features of the two forms of exchange rate regimes. Most of these variants are referred to as managed floats in acknowledgement of the role of both the market and official discretion in determining the level of the exchange rate.*