MONETARY POLICY REPORT

APRIL 2020
BANK OF BOTSWANA

STRATEGIC INTENT STATEMENTS

VISION

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

MISSION

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

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

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1. PREFACE

1.1 Purpose of the report

The Monetary Policy Report (MPR) is the main medium through which the Bank of Botswana (the Bank) informs the public about the conduct of monetary policy. It serves to meet the public's expectation of a transparent and accountable central bank in fulfilling the monetary policy mandate set out in the Bank of Botswana Act (Cap 55:01).

The MPR is published following the April, August and December meetings of the Monetary Policy Committee (MPC). The MPR presents the Bank's review of economic and inflation trends as well as policy performance. The report also provides 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 future policy choices. In this respect, the MPR promotes an understanding of the conduct of monetary policy in order to anchor public expectations of a low, predictable and sustainable level of inflation.

1.2 Monetary policy framework

The primary objective of the Bank's monetary policy is to achieve price stability. For Botswana, price stability is defined as a low, stable and predictable level of annual inflation, as measured by the consumer price index (CPI), that is within the Bank's medium-term objective range of 3 – 6 percent. The policy is also formulated with a view to safeguarding the stability of the financial system. The monetary policy framework is anchored on the crawling band exchange rate mechanism, which seeks to maintain a stable real effective exchange rate (REER) conducive for macroeconomic stability and the international competitiveness of domestic producers of tradeable goods and services. The Ministry of Finance and Economic Development (MFED), in consultation with the Bank, makes a recommendation on the parameters of the exchange rate mechanism (weights of currencies that comprise the Pula Basket and the rate of crawl) that determine the value of the Pula, for approval by His Excellency, the President. In addition, the Bank uses the Bank Rate to influence short-term interest rates to steer the economy through business cycles, thus contributing to sustainable economic development.

In evaluating policy options, the Bank pursues a forward-looking monetary policy with a central role for a medium-term inflation forecast. The Bank sets the policy to steer projected movements of inflation towards the medium-term objective, while taking into account the prevailing rate of crawl of the exchange rate mechanism, prospects for economic growth and developments relating to the stability of the financial system. The policy horizon is up to 3 years, and is evaluated on a rolling basis, because monetary policy affects price developments with a considerable lag estimated at up to four quarters. A proactive approach to setting policy necessitates a continuous review of the inflation outlook.

The monetary policy stance is signalled by the Bank Rate. To support this signal, the Bank uses open market operations, which entail, primarily, auctioning of Bank of Botswana Certificates (BoBCs) to, and engaging in Repo/Reverse Repo transactions with, commercial banks (primary dealers), as well as adjustment of the Primary Reserve Requirement (PRR) Ratio (although this is rarely used).

1.3 Decision-making process

Monetary policy is implemented in line with the decisions of the MPC. The Committee comprises: the Governor (Chairman); Deputy Governors; the Chief Operating Officer; Director of Research and Financial Stability Department and Deputy Directors of the Research and Financial Stability Department responsible for monetary policy and financial stability, respectively; Director and Deputy Director of the Financial Markets Department responsible for the domestic market operations; and Director of the Banking Supervision Department. The MPC holds six pre-scheduled meetings per year, at which the monetary policy stance is determined. However, the Committee can meet more often if need be. Prior to the commencement of the year, the dates for the MPC meetings for the ensuing year are announced.

1.4 Announcement of the monetary policy decision

The monetary policy decision is announced through a Press Release shortly after each MPC meeting. The Press Release informs the public of the Committee's decision regarding the Bank Rate and the reasons for the policy choice. The Governor holds a Press Briefing to allow for interaction with members of the media and to promote understanding of the Bank's economic analysis and policy stance. The Bank of Botswana recognises that transparency, consistency and predictability of the monetary policy framework are essential for sustainable and inclusive economic growth, hence communication is key to achieving the monetary policy objectives.

The first MPC meeting of the year, held in February, is accompanied by the issuance of the Monetary Policy Statement, through which the Bank reports on inflation trends, policy performance and the likely policy posture for the ensuing year. Subsequently, the MPR is produced for the April, August and December meetings. The MPR is published on the Bank website (www.bob.bw) within a week of the announcement of a policy decision.

2. EXECUTIVE SUMMARY

In 2020, the domestic economy is expected to experience a sharp deterioration in output resulting from the outbreak of the Covid-19 pandemic and the resultant adverse effects of the extreme social distancing and other containment measures imposed by the health authorities, globally and here at home. These measures, which are intended to contain the spread of coronavirus and save human lives, have invariably halted both global and domestic economic activity. Consequently, monetary policy will be implemented in an environment of suppressed medium term outlook for inflation, as a result of a slump in domestic demand and expected modest increase in foreign prices. Therefore, the current state of the economy and the outlook for both domestic and external economic activity provided scope for an accommodative monetary policy to support economic activity. Accordingly, the MPC decided to reduce the Bank Rate by 50 basis points to 4.25 percent and the primary reserve requirement (PRR) from 5 percent to 2.5 percent.

The overall risks to the inflation outlook are on the downside. Downside risks relate to weak domestic and global economic activity, due to the ongoing Covid-19 pandemic, the tendency of technological progress to lower costs and the likely decline in international commodity prices. These risks are moderated by the potential increase in international commodity prices beyond current forecasts, aggressive action by governments and major central banks to bolster demand as well as the anticipated supply constraints due to travel restrictions and lockdowns.

The Bank's formulation and implementation of monetary policy focuses on entrenching expectations of low, sustainable and predictable level of inflation through a timely response to price developments. The Bank remains committed to responding appropriately to ensure price and financial stability without undermining economic activity.

Headline inflation averaged 2.2 percent in the first quarter of 2020, a decline from an average of 3.4 percent in the first quarter of 2019, accounted for by the fall in the rate of price change for the transport and housing categories. Inflation is currently below the Bank's 3 - 6 percent objective range and it is expected to revert to within the range in the fourth quarter of 2020.

Gross domestic product (GDP) grew by 3 percent in 2019, compared to a faster expansion of 4.5 percent in 2018, mainly attributable to a contraction in output for the mining sector and a deceleration in the non-mining activity.

Annual growth in commercial bank credit increased to 10.2 percent in February 2020 from 6.6 percent in the corresponding period in 2019, reflecting, in part, the availability of bank funding/liquidity, as well as increased demand for household loans, particularly unsecured lending, mortgage and vehicle loans, influenced by the increase in public services salaries and the decline in lending rates following the 25 basis points reduction in the Bank Rate in 2019. Lending to the business sector declined as a result of loan repayments by some companies in the manufacturing sector.

At the end of December 2019, foreign exchange reserves amounted to P65.2 billion, a decrease of 8.7 percent from P71.4 billion in December 2018. The decrease was, among others, a result of a decline in exports receipts, especially diamonds, and the Southern African Customs Union

(SACU) revenue pool. The current account of the balance of payments is estimated to have recorded a deficit of P6.6 billion in the fourth quarter of 2019, compared to a revised deficit of P485 million during the same period in 2018, primarily due to a significant deficit in the merchandise trade account and the income account.

The nominal effective exchange rate (NEER) of the Pula depreciated by 0.2 percent in the twelve months to March 2020, consistent with the transition from an annual upward rate of crawl of 0.3 percent implemented in 2019 to an annual downward rate of crawl of 1.51 percent, implemented effective January 2020. The Pula appreciated by 11.1 percent against the South African rand but depreciated by 8.5 percent against the Special Drawing Rights (SDR) in the twelve months to March 2020. In the year to February 2020, the real effective exchange rate (REER) depreciated by 0.9 percent because of lower inflation in Botswana than in trading partner countries.

Global economic output grew by 2.9 percent in 2019, lower than the 3.6 percent for 2018. US gross domestic product (GDP) growth was constant at 2.1 percent in the third and fourth quarters of 2019, supported by government spending, household consumption expenditure, exports and residential fixed investment. GDP growth in the United Kingdom (UK) was relatively subdued at 0.5 percent in the fourth quarter of 2019, the same as in the previous quarter, reflecting heightened political uncertanity asociated with the December 2019 elections, which weighed on fixed investment and consumption and, in turn, restrained growth. Economic activity softened in the emerging market economies due to trade tensions between the US and China, tightening financial conditions, capital outflows and sluggish global demand. Meanwhile, in South Africa, output contracted by 1.4 percent in the fourth quarter of 2019, amid disruptive power cuts and waning investor confidence which had severely dented economic activity.

The global economic outlook was revised considerably downwards in the April 2020 World Economic Outlook (WEO), on account of the ongoing unprecedented exogenous shock caused by the Covid-19 pandemic. The pandemic has caused massive social and economic disruptions, as well as uncertainty in the global trade, tourism and financial markets. The April 2020 WEO forecasts the global economy to contract by 3 percent in 2020 (6.3 percentage points lower than the January 2020 forecast of 3.3 percent), before rebounding to a growth of 5.8 percent in 2021 as economic activity normalises, buoyed by policy support. However, these projections are uncertain, especially if a vaccine is not found within the next few months.

The global rough diamond price index decreased in the first quarter of 2020 against the backdrop of deteriorating manufacturers' demand resulting from the stringent measures put in place to combat Covid-19. In the first quarter of 2020, international oil (Brent crude and OPEC) prices significantly decreased to average about USD50 per barrel, influenced by mounting concerns of a slowdown in global growth due to sluggish demand following the spread of Covid-19 and disagreement between OPEC and its allies on further cuts to oil production, excess supply as well as the price war by Saudi Arabia and Russia. Meanwhile, the United Nations' Food and Agriculture Organisation (FAO) food price index increased in the first quarter of 2020, as prices of meat, vegetable oils and sugar rose.

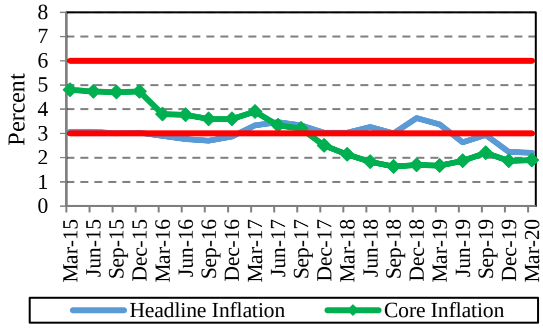
3. RECENT ECONOMIC DEVELOPMENTS

3.1 Inflation environment

Headline inflation decreases in the first quarter of 2020

Headline inflation averaged 2.2 percent in the first quarter of 2020 compared to 3.4 percent average inflation in the first quarter of 2019 (Chart 3.1). The decline is accounted for by the fall in the rate of price change for the transport and housing categories (Table 3.1).

Chart 3.1: Botswana Headline and Core Inflation

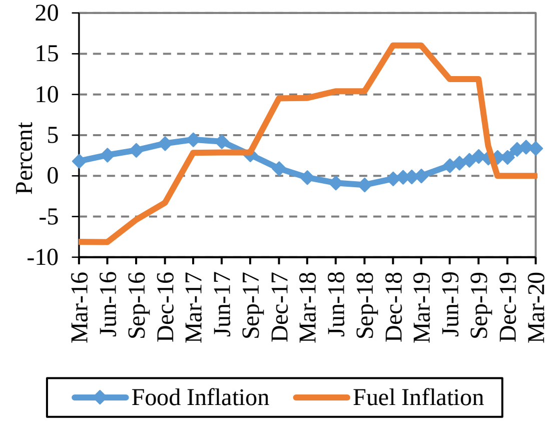


Source: Statistics Botswana and Bank of Botswana
Note: Core Inflation is headline inflation excluding administered prices.

Trimmed mean and inflation excluding food and fuel decrease, while inflation excluding administered prices increase

The trimmed mean inflation (CPITM) decreased to 1.9 percent in the first quarter of 2020, from 3.5 percent in the first quarter of 2019, while inflation excluding administered prices (CPIXA) averaged 2.7 percent compared to 1.7 percent in the same period (Table 3.1). Box 1 discusses administered prices. Inflation excluding food and fuel (CPIXFF) averaged 2.3 percent in the first quarter of 2020, slightly lower than the 2.4 percent in the corresponding quarter of 2019 (Table 3.1).

Chart 3.2: Food and Fuel Inflation



Source: Statistics Botswana and Bank of Botswana

Table 3.1: Annual Price Changes for Categories of Goods and Services (Percent)

Category of commodities	Basket Weights	Mar 2020	Q1 2020	Q1 2019
Food and non-alcoholic beverages	13.6	3.4	3.4	0.0
Alcoholic beverages and tobacco	4.3	4.8	4.9	0.6
Clothing and footwear	6.0	1.7	1.6	1.5
Housing, water, electricity, gas and other fuels	17.5	1.5	1.5	3.3
Furnishing, h/h equipment and routine maintenance	4.9	2.9	2.9	1.9
Health	3.4	0.9	0.9	1.1
Transport	23.4	0.8	0.9	9.9
Communications	6.9	0.3	0.3	-9.3
Recreation and culture	2.8	-0.3	-0.3	1.2
Education	4.6	4.7	4.7	3.1
Restaurants and hotels	3.7	3.6	3.7	2.6
Miscellaneous goods and services	9.0	5.1	5.1	6.1
Annual Inflation (All items)	**100.0**	**2.2**	**2.2**	**3.4**
CPITM		1.9	1.9	3.5
CPIXA		2.7	2.7	1.7
CPIXFF		2.3	2.3	2.4

Source: Statistics Botswana and Bank of Botswana calculations.

Box 1: Administered Prices

Administered price items in the CPI basket are goods or services for which prices are set or controlled by the Government outside the normal market price determination. These price adjustments are, however, to some degree, influenced by general price developments. For example, cost adjustments in some administered prices are often justified as a way of catching up with market prices, a response to higher input costs and a move towards cost recovery. However, monetary policy does not have any direct influence on these price changes and would, therefore, not trigger a direct policy response. Policy may, nevertheless, respond to the resultant second round effects as market prices also react.

There are currently 51 administered items (12.8 percent) out of the 400 items, accounting for a 32.3 percent weight of the CPI basket in Botswana (Table 3.2). Therefore, given the significant share of administered price items in the CPI basket, changes with respect to prices of these items have a significant influence on inflation and inflation expectations. For this reason, the Bank monitors and calculates the prospective and actual impact of the changes in administered prices on inflation, with a view to inform the forward-looking monetary policy of the Bank.

Table 3.2: Administered Items

Item code	Administered prices	Weights
147	Monthly rent BHC House Type LC48	0.294
148	Monthly rent BHC Type 2 "Improved"	0.379
161	Water: 10kls per month	1.168
162	Water: 20kls per month	0.779
164	Electricity, 100kwh per month	2.143
165	Electricity, 500kwh per month	1.428
167	Paraffin, per litre	0.064
237	Consultation with Government doctor	0.168
247	Rate to stay in a public hospital for 24 hours in a private ward (bed only)	0.799
261	Petrol per litre (95)	6.262
262	Diesel, per litre (50ppm)	3.708
270	Road worthiness test	0.022
271	Bus fare, single, Gaborone-Mochudi	0.706
272	Minibus fare, Gaborone-Johannesburg	0.631
273	Taxi fare (not "special")	0.794
274	Bus fare, single, Gaborone-Francistown	0.653
275	Minibus fare, within cities/towns/villages	0.913
278	Railway passengers fee	0.089
282	Local standard letter tariff rate	0.013
283	Air parcel to Europe (0.5 kg)	0.009
284	Rental of post office box	0.149
285	Standard letter (weight/size 120x235mm), air	0.021
291	Telephone installation	0.003
292	Telephone charges/rate between zone (per second charge)	0.004
293	Telephone charges/rate within zone (per second charge)	0.004
294	Telephone rate international (per second)	0.004
295	Telephone charges/rate to mobile (all mobiles)	0.005
296	Mascom charges/rate to all network (peak hour per minute charge)	0.697
297	Mascom charges/rate to all network (off/off-off peak hour per minute charge)	0.557
298	Orange charges/rate to all network (peak hour per minute charge)	0.697
299	Orange charges/rate to all network (off/off-off peak hour per minute charge)	0.557
300	Bemobile charges/rate to all network (peak hour per minute charge)	0.697
301	Bemobile charges/rate to all network (off/off-off peak hour per minute charge)	0.557
302	Mobile charge international charge (Orange+Mascom+Bemobile)	0.557
303	Prepaid phone card - short message service (SMS)	0.418
305	Mobile data pass (1GB; 1month)	0.836
328	Admission to premier league football match, uncovered stands	0.007
338	Kutlwano magazine	0.003
351	School fees (Senior Secondary) public school	0.434
352	Junior Secondary School fees (public)	0.650
354	College and university fees (BA Social Science)	0.285
383	Employee contribution to medical aid, standard benefit, 1, salary (600+)	1.550
384	Employee contribution to medical aid, high benefit, 1, salary (5000-8000)	1.250
385	Fully comp. insurance - Toyota Corolla 1.3	0.791
388	Levy + loan (P3500) interest on Self Help Housing Agency plot	0.060
390	Driver's license charge	0.025
391	Annual road tax - Hilux 2.0 pick-up	0.138
392	Annual road tax-Toyota Corolla 1.4	0.113
393	Fee for the issue of a passport	0.053
394	Council rates to house + plot valued at P200,000	0.091
397	Advertisement (20 words, Botswana Daily News newspaper)	0.025
	Total weight	**32.259**

Source: Statistics Botswana

3.2 Recent economic developments in Botswana

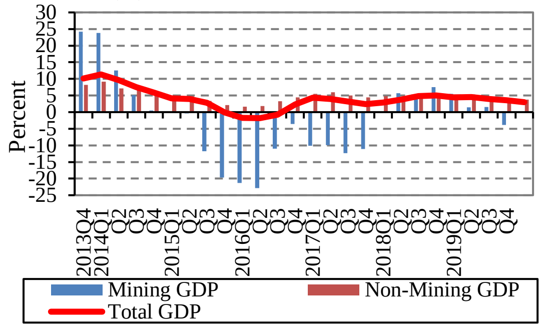
GDP growth decelerates in 2019

Real GDP grew by 3 percent in 2019, compared to a faster expansion of 4.5 percent in 2018 (Chart 3.3 and Table 3.3). The lower increase in output is attributable to the contraction in mining output and deceleration in output growth of the non-mining sector. Mining output contracted by 3.9 percent in 2019, compared to a growth of 7.6 percent in 2018, mainly due to weaker performance of the diamond, soda ash, copper and coal subsectors. In 2019, overall global demand for rough diamonds was adversely affected by the trade tension between the US and China, as well as mass protests in Hong Kong. Copper output contracted by 100 percent following cessation of production at the Mowana Mine in November 2018. Coal output decreased due to lower demand at Morupule B power station, which was operating below capacity, with one of the units placed under care and maintenance in the third quarter of 2019.

Non-mining GDP grew by 3.8 percent in 2019, compared to 4.1 percent in 2018. The lower growth in non-mining GDP was mainly due to a deceleration in output growth of the manufacturing, construction, transport and communications and social and personal services sectors. However, acceleration in growth of the finance and business services (5.9 percent) and the trade, hotels and restaurants[1] (4.1 percent) sectors, boosted overall growth of the non-mining sectors.

Meanwhile, Statistics Botswana reported that real GDP grew by 1.6 percent in the fourth quarter of 2019, from 4.2 percent in the fourth quarter of 2018[2]. Output in the fourth quarter of 2019 decreased by 1.5 percentage points to 1.6 percent from a faster growth of 3.1 percent registered in the third quarter of 2019.

Chart 3.3: GDP Growth Rates



Source: Statistics Botswana

Note: Growth rates are reported on a rolling 12-month basis.

In terms of GDP by the expenditure, government final consumption grew by 3.2 percent in 2019, compared to 3.7 percent in 2018 (Table 3.3). This was attributable to the deceleration in growth in central government consumption, from 3.9 percent to 3.5 percent. In addition, growth in household final consumption decelerated to 3.5 percent in 2019 from 4.1 percent in 2018. The reduced growth was mainly due to lower expansion in marketed household final consumption[3] (from 4.3 percent to 3.7 percent), reflecting lower growth in the importation of goods and services in the same period.

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1 This sector also includes tourism.

2 Statistics Botswana calculates annual GDP growth for a given quarter on the basis of quarterly output in that period compared to the output for the corresponding quarter in the previous year.

3 Marketed household consumption refers to goods and services purchased in the markets and consumed by households.

Gross Fixed Capital Formation (GFCF) grew by 6.4 percent in 2019, compared to 8.1 percent in 2018. The lower increase in GFCF was due to the notable deceleration in investment in transport and equipment (from 18.9 percent to 15.5 percent), as well as investment in machinery and equipment (from 16.3 percent to 9.8 percent), reflecting the slower growth in imports of machinery and electrical equipment, and vehicles and transport equipment. Meanwhile, investment in construction expanded by 3.9 percent in 2019, compared to 3.5 percent in 2018.

Table 3.3: Real GDP Growth by Sector and Expenditure (Percent)

	2018Q4	2019Q3	2019Q4
Total GDP	**4.5**	***3.6*(3.7)**	**3.0**
By Sector			
Mining	7.6	1.6	-3.9
Non-Mining	4.1	3.9 (4.0)	3.8
Agriculture	2.6	0.7	-0.1
Manufacturing	3.4	*3.3* (3.5)	2.8
Water and Electricity	11.3	-0.6(-1.2)	6.3
Construction	3.7	3.1	3.0
Trade, Hotels and Restaurants	3.6	*3.9*(4.2)	4.1
Transport and Communications	6.4	5.9	5.3
Finance and Business Services	5.0	5.6	5.9
General Government	3.4	3.9	3.7
Social and Personal Services	3.6	3.3	3.0
By Expenditure			
Government Final Consumption	3.7	2.8	3.2
Household Final Consumption	4.1	*3.1* (3.0)	3.5
Gross Fixed Capital Formation	8.1	6.8	6.8
Exports	7.2	*-5.1*(-5.5)	-16.6
Imports	11.8	*11.1* (3.4)	6.7

Source: Statistics Botswana and Bank of Botswana calculations

Note: The figures in italics are revisions of the figures in brackets, previously reported in the Q3 estimates.

Diamond production decreased in the first quarter of 2020

Debswana produced 5.6 million carats of diamonds in the first quarter of 2020, 5.1 percent lower than the 6 million carats produced in the same period in 2019, mainly due to lower production at Orapa, Letlhakane and Damtshaa (OLD) Mines. Production at the OLD Mines decreased by 6.5 percent mainly reflecting challenges related to commissioning of new plant infrastructure and maintenance. Meanwhile, production at Jwaneng Mine also decreased by 4.1 percent in the same period, largely attributable to the planned processing of lower grade material. Overall, the effects of Covid-19 on diamond production were limited in the first quarter of 2020 since disease containment measures were introduced towards the end of the quarter.

Lucara Diamond Corporation (Karowe Mine) increased production by 18.3 percent to 433 060 carats[4] in 2019, from 366 086 carats in 2018. The increase in production is attributable to an increase in the recovery of smaller-sized diamonds and re-processing of tailings in the period under review. A total of 786 special stones (single diamonds larger than 10.8 carats) were recovered in 2019, including 31 diamonds greater than 100 carats (such as the historic 1 758 carats Sewelô). Overall, for 2020, Karowe Mine anticipates producing between 370 000 and 410 000 carats. However, due to the deterioration in diamond prices associated with the global spread of Covid-19, Lucara has, effective March 31, 2020, decided to suspend its 2020 guidance until further notice, due to the uncertain outlook for the year.

Budget deficit recorded in the third quarter of the 2019/20 fiscal year

Government budget was in a deficit of P4.1 billion in the third quarter of the 2019/20 fiscal year (Table 3.4). The deficit was largely attributable to the less-than-anticipated revenue and grants, resulting from lower mineral revenue than was projected. Total revenues and grants were P11.8 billion in the third quarter of the 2019/20 fiscal year, compared to P15.2 billion anticipated in the revised budget for the year, assuming equal quarterly distribution. Total government expenditure and net lending was P16 billion, slightly lower than the anticipated level of P17.2 billion.

Table 3.4: Quarterly Budget Outturns (P Million)

	Total Revenues and Grants	Total Expenditure and Net Lending	Budget Surplus/ Deficit
2018/19 Q3	13 421	13 939	-508
2018/19 Q4	12 386	18 939	-6 553
2019/20 Q1	17 094	14 903	2 190
2019/20 Q2	13 513	17 974	-4 461
2019/20 Q3	11 825	15 953	-4 128

Source: Cash Flow Unit, Ministry of Finance and Economic Development

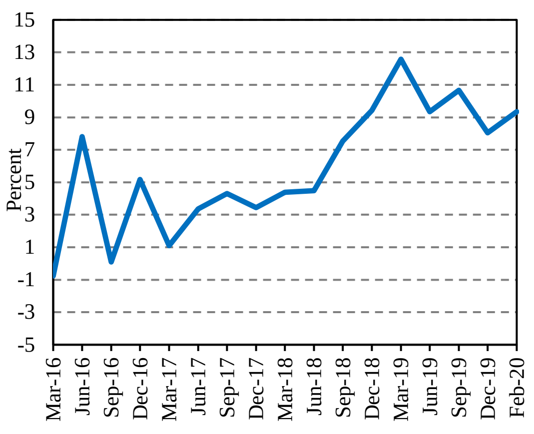
[4] This includes 29 990 carats recovered from the re-processing of tailings from previous milling.

3.3 Monetary developments

Growth in banking sector assets increases in February 2020

Annual growth in banking sector assets was 9.3 percent in the twelve months to February 2020 (Chart 3.5). This was due to the overall increase in the growth of loans and advances, which accounted for the largest proportion of commercial banks' assets (61 percent), as well as the growth in balances due from foreign banks and outstanding BoBCs. In February 2019, annual growth in banking sector assets was 10.1 percent.

Chart 3.5: Year-on-Year Commercial Banks' Growth in Total Assets



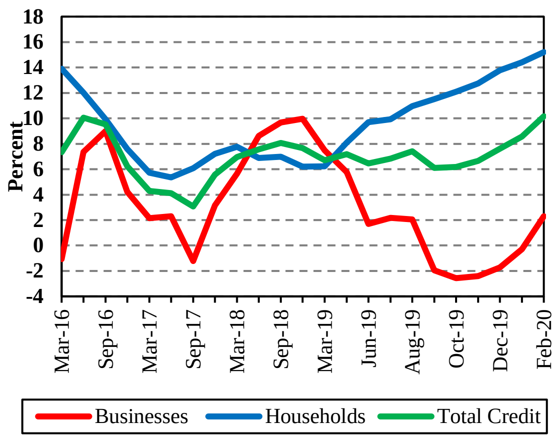
Source: Commercial Banks

Credit growth accelerates in February 2020

Year-on-year growth in commercial bank credit increased to 10.2 percent in the twelve months to February 2020, from 6.6 percent in the corresponding period in 2019 (Chart 3.6). The higher growth in commercial bank credit is, in part, indicative of the continuing availability of bank funding/liquidity, reflecting growth in customer deposits, which enabled banks to meet the rise in demand for credit. Household loans increased significantly by 15.2 percent in the twelve months to February 2020, from 6.3 percent in the corresponding period in 2019, particularly unsecured lending (accessed through scheme loan arrangements), mortgage and motor vehicle loans, influenced by the increase in public services salaries as well as the decline in lending rates following the reduction in the Bank rate in 2019.

Annual growth in lending to the business sector declined from 7.1 percent in the twelve months to February 2019 to 2.3 percent in the corresponding period in 2020, as a result of repayment of overdraft facilities by some companies in the manufacturing sector, including those in the diamond cutting and polishing industry, construction, finance as well as trade sectors. Meanwhile, utilisation of credit facilities by parastatals increased in the year to February 2020.

Chart 3.6: Year-on-Year Commercial Banks' Growth in Total Credit

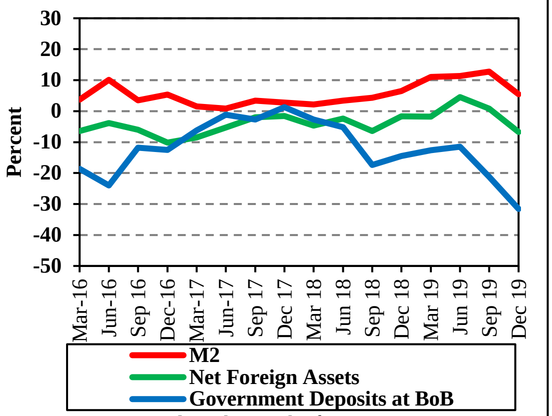


Source: Commercial Banks

Growth in money supply increases in December 2019

Annual growth in money supply (M2) increased to 8 percent in the twelve months to December 2019 compared to 8.3 percent in the corresponding period in 2018 (Chart 3.7). The expansionary effect was due to the decrease in net foreign assets and the increase in credit to the private and parastatal sectors, as well as the decline in government deposits at Bank of Botswana to fund government operations.

Chart 3.7: Year-on-Year Growth in Money Supply



Source: Commercial Banks, Bank of Botswana

The nominal BoBC stop-out yields decreased in the first quarter of 2020

The 3-month BoBC stop-out yield decreased from an average of 1.64 percent in the first quarter of 2019 to 1.52 percent in the corresponding period in 2020. Meanwhile, the real interest rate for the 3-month BoBC increased from -1.98 percent in the fourth quarter of 2018 to -0.72 percent in the corresponding period in 2019, mainly reflecting the larger fall in inflation compared to the nominal interest rate in the same period. The 7-day BoBC stop-out yield decreased from an average of 1.50 percent in the fourth quarter of 2019 to 1.45 percent in the first quarter of 2020.

In March 2020, the stop-out yield for the 7-day BoBC[5] was 1.46 percent, slightly higher than the 1.45 percent in February 2020, while the 3-month BoBC rate was constant at 1.52 percent, in the same period. The real rate of interest for the 7-day BoBC increased slightly from -0.73 percent in February 2020 to -0.72 percent in March 2020 reflecting the slight increase in nominal yields, while inflation remained unchanged. The real 3-month BoBC yield was constant at -0.67 percent in the same period. Box 2 discusses reforms to monetary operations.

Credit ratings reviewed

Moody's Investors Service affirmed Botswana's sovereign credit rating of 'A2' for long-term bonds denominated in both domestic and foreign currency, as well as a stable outlook in March 2020. The ratings were supported by the strong external and fiscal buffers, a well-managed economy and low public debt, as well as the country's robust public institutions. However, the ratings could be revised downwards if the fiscal and external positions were to deteriorate considerably, either due to underperformance in the diamond sector, hence a weaker economic growth, or a more-than-anticipated increase in fiscal spending. In general, the ratings were constrained by the country's narrow economic base, which continues to rely heavily on the diamond sector, despite efforts to enhance private sector participation and diversify the economy.

During the same period, S&P Global Ratings downgraded Botswana's sovereign credit rating for long-term foreign and domestic currency bonds from "A-" to "BBB+", and retained "A-2" for short-term foreign and domestic currency bonds. The stable economic outlook was maintained. The ratings were undermined by the prolonged weakening of the external market for diamonds, pressures on expenditure due to the increase in public sector wages and the resultant expected gradual decline of the country's strong fiscal and external buffers in the near to medium term. The stable outlook was premised on maintenance of relatively low external debt compared to external assets. The review acknowledged the robust institutional frameworks that foster fiscal prudence and low government debt, and monetary policy framework that supports macroeconomic stability.

[5] Effective April 30, 2019, the Bank introduced a 7-day BoBC to replace the 14-day BoBC. The reduction of the BoBC maturity was to provide the Bank and commercial banks with a shorter and simpler forecasting framework horizon for liquidity management.

Box 2: Reforms to Monetary Operations Framework

The Bank evaluates the monetary policy implementation framework on a regular basis for effectiveness, and introduces refinements where necessary. In that regard, banks continue to take advantage of the additional flexibility for effective liquidity management by the extension, in 2017, of eligible collateral to include government securities of all maturities for access to the Bank of Botswana Credit Facility. In addition, the Bank introduced the 7-day BoBC as the main instrument for conducting monetary operations to replace the 14-day paper together with 'reserve averaging' in the determination of the Primary Reserve Requirement (PRR).

Both measures, which were introduced on April 30 and October 9, 2019, respectively, were welcomed enthusiastically by the market as expected, providing the basis for improved liquidity management by both the Bank and the commercial banks. In particular, commercial banks are actively using the Primary Reserve account as a tool for effective management of liquidity (only two of the banks currently do not use it on a regular basis) and the Bank envisages that this will, over time, lead to reduced demand for excess reserves held by commercial banks for precautionary purposes, thus freeing up additional resources for productive lending. This was in the context of removing the ceiling of P10 billion on BoBC issuance, allowing the Bank to deal more effectively with any surges in market liquidity.

The Bank undertook extensive consultation with local commercial banks and research, including review of practice in other jurisdictions in 2019 to help guide possible reforms relating to further strengthening of the potency of monetary policy transmission. These include alternatives to the Bank Rate as the 'anchor policy rate' and establishing a more effective interest rate corridor around this rate to support development of the interbank market. Proposals in this regard are expected to be announced in the near future.

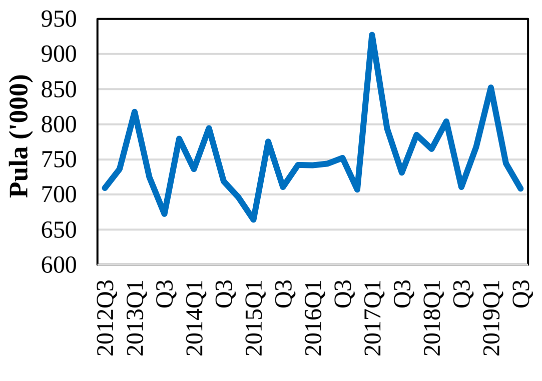
3.4 Asset markets

Property market remains weak in the third quarter of 2019

According to the latest Riberry Report[6] (third quarter of 2019), the residential rental market weakened in the third quarter of 2019 compared to the previous quarter on account of weaker demand for both the upper and middle end properties. However, the rental market enjoys good demand and supply for properties in the lower end.

Overall, the average price for residential properties sold in the third quarter of 2019 decreased by 4.8 percent to P708 180 compared to the previous quarter (Chart 3.8), reflecting the lower value of properties traded in the quarter under review (477 properties were sold in the third quarter of 2019 compared to 474 in the previous quarter). Looking ahead, the demand for lower-end prime located residential housing is expected to improve given affordability of properties in this category relative to others (middle and upper-end).

Chart 3.8: Riberry Average Prices



The market for office space remains weak due to increasing supply from completed construction developments, such as the Botswana Unified Revenue Service building at the Gaborone Central Business District (CBD). Despite the general weak demand for office space, there has been reasonable take-up of office space at the CBD by Government, a major office space occupier, as well as by some corporates. However, for office locations away from CBD, such as Gaborone International Finance Park and Gaborone International Commerce Park, there is less demand and some existing tenants are relocating from those areas to the CBD, which is considered more convenient.

The supply for office space is likely to increase further going forward, given the ongoing construction projects and planned office buildings at the CBD, such as by the Botswana Housing Corporation and Water Utilities Corporation. These will further exert downward pressure on rentals, especially in the decentralised office locations.[7] Meanwhile, the demand for retail space remains fair across all market segments, with proposed major shopping centres in the CBD and Mogoditshane. In addition, other centres with good demand for retail space are Maun, Francistown, Mahalapye and Palapye. With regard to industrial property, the supply of bigger warehouse space has decreased, while the demand has improved. The supply for prime location industrial space is expected to decrease, going forward, given that most of the centrally located industrial land is almost fully developed and occupied.

Stock market index declines

The Domestic Companies Index (DCI) declined by 5 percent in the twelve months to March 2020 compared to a reduction of 8.2 percent in the year to March 2019 (Chart

[6] This is a quarterly report produced by independent valuers, Riberry Botswana (Pty) Ltd.

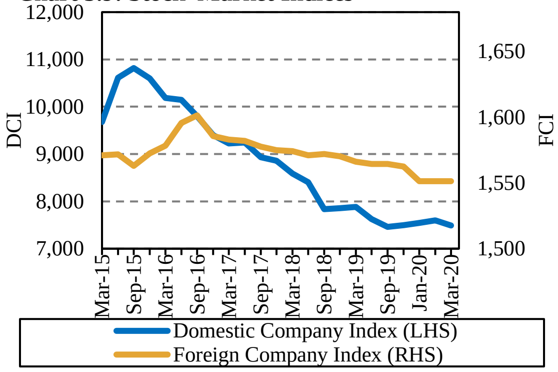
[7] Prime rentals are about P100/m^2. However, rentals in secondary areas, such as Gaborone International Finance Park (also known as Kgale Mews), situated at the foot of Kgale Hill adjacent to Game City Shopping Mall cost P75/m^2, while prime industrial areas like Gaborone International Commerce Park cost P65/m^2.

3.9). The decline was mainly due to the lower share prices for Stanchart, Seedco and Letshego, which fell by 55.1 percent, 47.3 percent and 46.9 percent, respectively, in the same period.

According to Stockbrokers Botswana,[8] the continuous decline in the DCI was reflective of the low trading activity and liquidity as well as sluggish corporate earnings due to restrained economic environment.

The Foreign Companies Index (FCI) declined by 1 percent in the year to March 2020, compared to a decline of 0.5 percent in the corresponding period ending in March 2019 (Chart 3.8). This was largely attributed to the year-on-year decrease in share price for Tlou (-48.7 percent) and Lucara (-51 percent), on account of low trading activity and liquidity.

Chart 3.9: Stock Market Indices



Source: Botswana Stock Exchange

3.5 Balance of payments (BoP)

Current account records a deficit in the fourth quarter of 2019

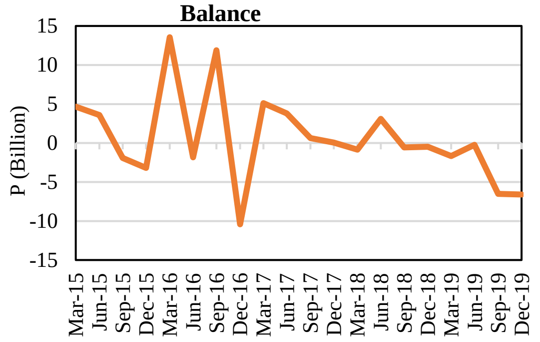
The current account is estimated to have recorded a deficit of P6.6 billion in the fourth quarter of 2019, compared to a revised deficit of P485 million during the corresponding period in 2018 (Chart 3.10). The merchandise trade and income accounts recorded a combined deficit of P9 billion, which was particially offset by a surplus of P3.4 billion in the current transfer account, hence an overall defict of P6.6 billion. Within the merchandise trade account, exports declined by 32.5 percent, while imports declined by only 2.7 percent leading to a relatively large negative overall merchandise trade accountthan in 2018.

Diamond exports, which accounted for 90.6 percent of total exports of goods, fell from P60.4 billion in 2018 to P51 billion in 2019. During the same period, diamond imports increased from P18 billion to P20 billion. The decrease in diamond exports stemmed from, among others; the trade tension between the US and China, as well as mass protests in Hong Kong, which had a negative impact of diamond trading in general.

The other major commodities which contributed to the decrease in exports include copper and nickel, which declined by 96.2 percent. The reduction in copper and nickel exports was due to the base effects associated with the cessation of production by the Mowana Mine in November 2018 on account of working capital constraints.

The negative balance in the income account mainly resulted from the payments of dividends and reinvested earnings to foreign investors, mainly by the mining sector, which were estimated at P11.8 billion.

Chart 3.10: Quarterly Current Account Balance



Source: Bank of Botswana

[8] Stockbrokers Botswana is a brokerage firm registered and licensed with the Botswana Stock Exchange Limited.

Net outflows in the financial account in the fourth quarter of 2019

The overall financial account had an estimated net outflow of P54 million during the fourth quarter of 2019 compared to a revised net inflow of P1.9 billion in the fourth quarter of 2018. The outflow was mainly attributable to increased offshore investment by pension funds.

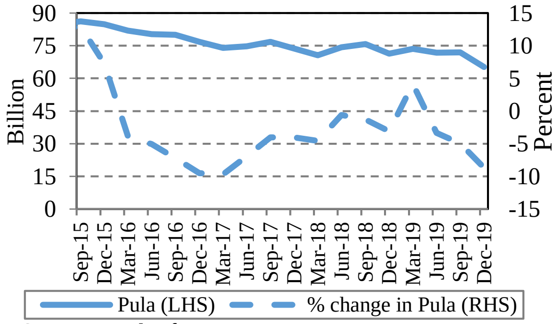
The overall BoP was in a deficit of P12 billion in December 2019, compared to a deficit of P4.2 billion in December 2018. The deficit was mainly attributable to government financial obligations and payments for imports in the context of slower growth in exports and reduced revenue inflow from SACU.

Foreign exchange reserves decrease

As at the end of December 2019, foreign exchange reserves amounted to P65.2 billion, a decrease of 8.7 percent from P71.4 billion in December 2018 (Chart 3.11). The decrease was, among others, a result of lesser receipts from diamond exports and the SACU revenue pool.

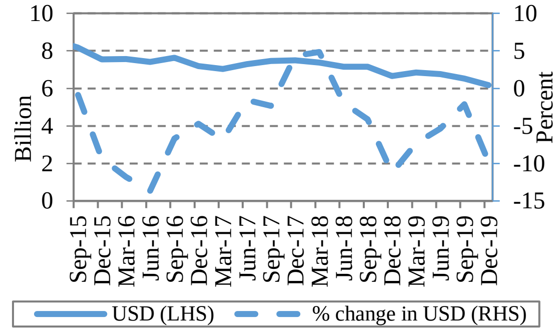
In foreign currency terms, the level of reserves decreased by 7.5 percent from USD6.7 billion in December 2018 to USD6.2 billion in December 2019 (Chart 3.12). The reserves also decreased by 6.3 percent from SDR4.8 billion to SDR4.4 billion over the same period. The level of reserves as at the end of December 2019 was equivalent to 12.6 months of import cover of goods and services.

Chart 3.11: Foreign Exchange Reserves in Pula and Annual Percentage Change



Source: Bank of Botswana

Chart 3.12: Foreign Exchange Reserves in US Dollars and Annual Percentage Change



Source: Bank of Botswana

3.6 Exchange rate developments

For 2020, the Bank's implementation of the exchange rate policy (Box 3) entails the Pula basket weights of 45 percent for the South African rand and 55 percent for the SDR, which were maintained from 2019. A downward annual rate of crawl of 1.51 percent was implemented effective January 1, 2020, and revised to a new annual downward rate of crawl of 2.87 percent with effect from May 1, 2020. The economy could benefit from a measured depreciation of the Pula against trading partners in order to support exports and promote diversification admist sluggish economic activity, while there is no upside threat to the inflation objective.

Bilaterally, the Pula appreciated by 11.1 percent against the South African rand but depreciated by 8.5 percent against the SDR in the twelve months to March 2020 (Chart 3.13). Against the SDR constituent currencies, the Pula depreciated by 11.8 percent against the Japanese yen, 9.9 percent against the US dollar, 8 percent against the euro, 4.9 percent against the Chinese renminbi and 4.5 percent against the British pound.

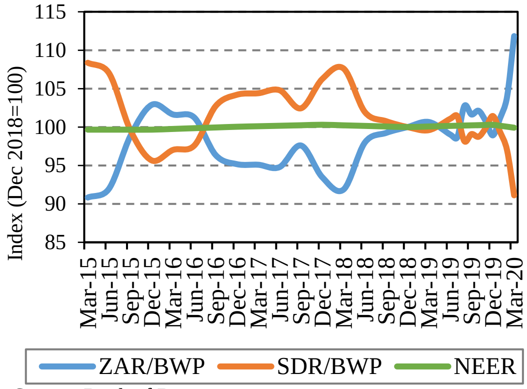
The movement of the Pula against the SDR constituent currencies largely reflects the performance of the South African rand against the SDR currencies. Notably, in the same review period, the South African rand depreciated by 17.7 percent against the

SDR. Against the SDR constituent currencies, the South African rand depreciated by 20.6 percent against the Japanese yen, 18.9 percent against the US dollar, 17.2 percent against the euro, 14.4 percent against the Chinese renminbi and 14.1 percent against the British pound.

The South African rand depreciated along with other emerging market currencies, on the back of deteriorating investor sentiment towards emerging market assets. Emerging market currencies, including the South African rand, have weakened the most due to low appetite for risky assets, as investors realise that the more widespread the Covid-19 virus, the longer it will take for economic activity to return to normal and, therefore, resort to safe haven currencies, such as the US dollar.

On the regional front, Moody's investor services cut its 2020 growth forecast for South Africa to 0.7 percent in February 2020, from the 1.5 percent forecast in September 2019, attributing the downward revision to the detrimental impact of the power supply constraints on manufacturing and mining activity, which dampened the demand for the South African rand. Moreover, the South African rand depreciated after Moody's raised concerns on the 2020/21 budget and warned that risks remain skewed towards a higher debt path for South Africa. The fiscal deficit is expected to widen to around 7 percent of GDP in the next few years.

Chart 3.13: Nominal Exchange Rate Indices

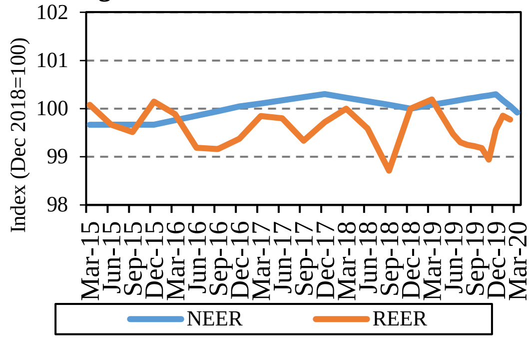


Source: Bank of Botswana

NEER depreciated in March 2020

The NEER of the Pula depreciated by 0.2 percent in the twelve months to March 2020 (Chart 3.14), consistent with the transition from an annual upward rate of crawl of 0.3 percent implemented in 2019 to an annual downward rate of crawl of 1.51 percent, effective January 2020.

Chart 3.14: Nominal and Real Effective Exchange rates



Source: Bank of Botswana

REER depreciated in February 2020

The REER depreciated by 0.9 percent in the twelve months to February 2020 (Chart 3.14), due to lower inflation in Botswana (2.2 percent) than in trading partners (3.2 percent). With respect to bilateral movements against the Pula basket currencies, the real Pula exchange rate (using headline inflation) appreciated by 3.1 percent against the South African rand and depreciated by 4.1 percent against the SDR. Regarding the SDR constituent currencies, the Pula depreciated by 5.9 percent against the US dollar, 5.7 percent against the Japanese yen, 4 percent against the Chinese renminbi, 2.3 percent against the British pound and 1.6 percent against the euro.

Box 3: Botswana's Exchange Rate Framework

The Exchange Rate Policy

Botswana's exchange rate policy is to maintain a stable real effective exchange rate to support competitiveness of domestic industry in the international and domestic markets. By extension, the policy supports the national objective of economic diversification, together with the associated industrial development and employment creation objectives. The Pula exchange rate is determined based on a peg to a basket of currencies, the choice of which is guided by the trade pattern and currencies used in international trade and payments. It is pegged to a trade-weighted basket of currencies that comprise the South African rand and the International Monetary Fund's unit of account, the Special Drawing Rights (SDR). 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.

The main reasons for choosing a pegged exchange rate rather than a floating exchange rate was the desire to avoid "Dutch Disease" problems as diamond production and exports increased. The Dutch Disease problems can arise when rising export earnings from the dominating export sector and the resultant inflows of foreign exchange cause both the nominal and real exchange rate to appreciate, thereby, eroding the competitiveness of local producers of tradeable goods and services, hence undermine other exports (and the production of other tradeable commodities more generally). As a result, the economy may become less diversified as other tradeable goods sectors fail to grow (or go into decline).

Current Exchange Rate Framework

The crawling band mechanism was adopted in May 2005 to allow for continuous gradual adjustment (crawling) of the Pula exchange rate to avoid misalignment (i.e., either over-valuation or under-valuation) of the exchange rate. This was an improvement over the discrete adjustment (through either devaluation or revaluation) of the exchange rate which could reflect policy failures in other areas as well as undermine the credibility of the crawling peg mechanism. In the crawling band 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 inflation differential is positive (negative), a downward (upward) crawl is implemented; and when they are equal (zero inflation differential), the rate of crawl ought to be zero. A gradual downward adjustment of the annual rate of crawl, such as 2.87 percent effective May 1, 2020 (revised from -1.51 percent effected at the beginning of 2020), means that the exchange rate is adjusted daily in very small fixed amounts, which accumulate to an annual change of -2.87 percent.

An important goal of the exchange rate policy is the maintenance of a stable real effective exchange rate (REER). In line with this objective, the authorities closely monitor the relative inflation performance between Botswana and its trading partner countries.

3.7 Recent global economic developments

Global growth subdued

According to the International Monetary Fund's (IMF) April 2020 World Economic Outlook (WEO), global output growth for 2019 is estimated at 2.9 percent, lower than the 3.6 percent estimate for 2018 (Table 3.5). The lower growth in 2019 reflects subdued growth for emerging market and developing economies, notably India, where domestic demand had slowed more sharply than expected amid slower credit expansion and stress in the non-bank financial sector. Furthermore, global economic performance in 2019 was undermined by social unrest in some countries, such as Hong Kong and Chile, as well as adverse weather conditions.

The IMF revised the growth forecasts significantly downwards from the January 2020 WEO Update on account of the the outbreak and spread of Covid-19 and the resultant necessary protection measures that are severely impacting on global economic activity. These measures include: the initial travel restrictions, lockdowns; business closures adversely affecting air travel, tourism and manufacturing globally, while stock markets have become volatile and generally fallen. Consequently, the global economy is projected to contract sharply by 3 percent in 2020.

US economic activity contracts in the first quarter of 2020

In the US, output contracted by 4.8 percent in the first quarter of 2020,[9] from a growth of 2.1 percent in the fourth quarter of 2019. The decline in economic activity reflected negative contributions from personal consumption expenditures, particularly services such as health care; non-residential fixed investment; exports, predominantly travel services; and private inventory investment that were partly offset by positive contributions from residential fixed investment, federal government spending, and state and local government spending.

Euro area growth slows

The euro area GDP growth was 0.1 percent in the fourth quarter of 2019, lower than the 0.3 percent in the third quarter. The lower expansion in the fourth quarter of 2019 was on account of the weak performance of the industrial sector in the context of sluggish demand from trading partners, as well as a less supportive global trade environment, including risk associated with a no-deal Brexit.[10]

Growth unchanged in the UK

GDP growth in the UK was flat (registered zero percent) in the fourth quarter of 2019, falling from a revised growth of 0.5 percent in the third quarter, as growth in the services sector slowed and household consumption was subdued, while manufacturing output declined. In contrast, government spending provided support for economic activity.

Emerging markets' growth moderates

For emerging market economies, output growth softened, primarily due to trade tensions between the US and China, tightening financial conditions, capital outflows and sluggish global demand.

China's economy contracted for the first time since 1992 in the first quarter of 2020, reversing a 6 percent expansion in the fourth quarter of last year, as production

[9] This is an estimate based on incomplete data and subject to further revision. The "second" estimate, based on more complete data, will be released on May 28, 2020.

[10] The UK exited the European Union as expected on January 31, 2020 and has entered a transition period until December 31, 2020 in which it will remain in both the EU customs union and single market.

and spending were curtailed by the Covid-19 lockdown. Industrial production, retail sales of consumer goods, investment in fixed assets, and imports and exports fell by 1.1 percent, 19 percent 16.1 percent 6.4 percent, respectively.

In India, GDP grew year-on-year by 4.7 percent in the fourth quarter of 2019, lower than the 5.1 percent expansion in the third quarter, the weakest growth since the first quarter of 2013 but matching market expectations. Contraction in the manufacturing sector, as well as the slowdown in construction contributed to the overall slowdown of the economy.

South African output contracts further

Regionally, output in South Africa contracted by 1.4 percent in the fourth quarter of 2019, following a contraction of 0.8 percent in the third quarter. The contraction was worse than the market expectation of a decline of 0.1 percent and was mainly due to the unprecedented rolling out of load shedding which has severly dented the economy. Overall, 7 out of 10 industries contracted in the fourth quarter of 2019, with agriculture, transport and communication, as well as construction recording the largest declines. Meanwhile, Moody's credit rating agency downgraded South Africa to junk-status at its review meeting on March 27, 2020, due to continuing deterioration in fiscal strength and structurally weak growth, which were not expected to be effectively addressed by the policy actions in place.

Table 3.5: Growth Estimates and Projections

	Estimate		Projection	
	2018	**2019**	**2020**	**2021**
Global	**3.6**	**2.9**	**-3.0**	**5.8**
Advanced economies	**2.2**	**1.7**	**-6.1**	**4.5**
USA	2.9	2.3	-5.9	4.7
Euro area	1.9	1.2	-7.5	4.7
UK	1.3	1.4	-6.5	4.0
Japan	0.3	0.7	-5.2	3.0
EMDEs	**4.5**	**3.7**	**-1.0**	**6.6**
China	6.6	6.1	1.2	9.2
Brazil	1.3	1.1	-5.3	2.9
India	6.8	4.2	1.9	7.4
Russia	2.3	1.3	-5.5	3.5
South Africa	0.8	0.2	-5.8	4.0
Botswana	**4.5**	**3.0**	**-13.1**	**3.9**

Source: IMF WEO April 2020 and MFED for Botswana.

Note: EMDEs stands for emerging market and developing economies.

Global commodity prices

Diamond prices decrease in the first quarter of 2020

The global rough diamond price index decreased by 2.5 percent from 141.4 in the fourth quarter of 2019 to 137.8 in the first quarter of 2020 as the spread of the coronavirus and counter-pandemic measures implemented around the globe severely suppressed manufacturers' demand for rough diamonds. Moreover, the decline reflects the deteriorating consumer and investor sentiment, excess supply of smaller diamonds and underperformance in the Indian consumer market. In March 2020, the global rough diamond price index averaged 134, lower than the 140.4 in February. In Botswana, De Beers cancelled its third rough diamond sale cycle of 2020 in response to public health restrictions on the movement of people and goods in Botswana, as well as other participating countries such as South Africa and India.

Similarly, the global polished diamond price index decreased by 0.4 percent from 210.4 in the fourth quarter of 2019 to 209.7 in the first quarter of 2020. In March 2020, the global polished diamond price index averaged 209.4 as the spread of Covid-19 continued to weigh on retail sales, with trade fairs and other retail sales boosting events cancelled. Moreover, the virus has had ripple effects on diamond supply chains due to the China lockdown. The prevailing weaker demand for diamond jewellery and liquidity constraints, had an impact on sales of luxury goods, including diamond jewellery.

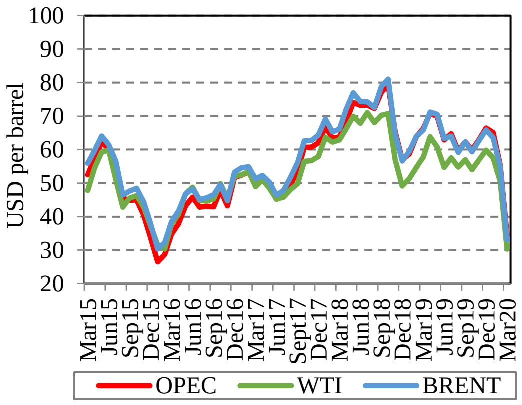
Oil prices decrease significantly in the first quarter of 2020

International oil prices (Brent crude and OPEC) averaged slightly above USD50 per barrel in the first quarter of 2020 (Chart 3.15). The OPEC reference crude oil basket price and the Brent crude decreased by 18.1 percent and 19.3 percent, from an average of USD63.11 per barrel and USD62.66 per barrel in the fourth quarter of 2019 to an average of USD51.68 per barrel and USD50.55 per barrel, respectively, in the first quarter of 2020. The price of the West Texas Intermediate (WTI)[11] also decreased by 18.9 percent from an average of USD56.92 per barrel in the fourth quarter of 2019 to an average of USD46.13 per barrel in the first quarter of 2020. International oil prices decreased in response to excess supply, reduced demand for crude oil and resultant competitive bidding down of prices by Saudi Arabia and Russia.

In March 2020, Brent crude oil basket averaged USD33.05 per barrel, a decrease from an average of USD55 per barrel in February. Similary, OPEC crude oil price decreased to an averagee of USD34.45 per barrel from USD55.49 per barrel in the same period. Oil prices have been trending downwards since the beginning of March 2020 due to the price war between Saudi Arabia and Russia, with OPEC crude oil price reaching a daily low of USD21.66 per barrel on March 30, 2020, while Brent crude oil price and WTI were USD22.94 per barrel and USD 20.09 per barrel, respectively, on the same day.

Major oil producers agreed to cut oil production by 9.7 million barrels per day from May to June 30, 2020 and by 7.7 million barrels per day from July to December 2020 followed by 5.8 million barrels per day from January 2021 to April 2022, in order to reduce excess supply and curtail the fall in prices. Despite this agreement, oil prices have continued to fall, with the WTI futures price for May 2020 declining significantly to minus USD37.63 on April 20, 2020 on fears of lack of sufficient storage space despite output cuts. Brent futures ended the day down sharply, at USD25.41 a barrel, while OPEC price was USD14.19. Overall, developments in the international oil market imply downward pressure on Botswana inflation.

Chart 3.15: Oil Prices (monthly averages)



Source: OPEC and US Energy Information

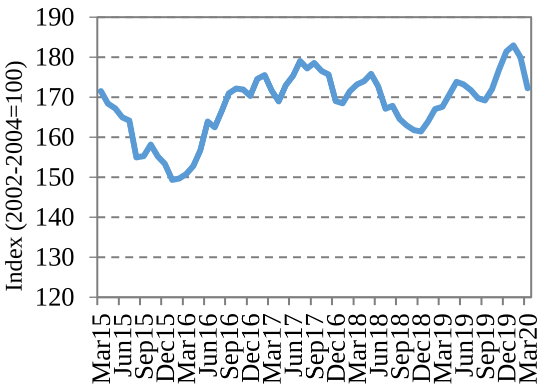
Food prices increased in the first quarter of 2020

According to the United Nations Food and Agriculture Organisation (FAO), the global food price index averaged 178.4 points in

[11] WTI is a grade of crude oil used as a benchmark for oil pricing in the US.

the first quarter of 2020, a 6.4 percent increase from an average of 167.6 points in the corresponding period in 2019. The increase in prices was attributable to a significant rise in vegetable oils and sugar prices, as well as meat prices, as the outbreak of African Swine Fever in East Asia dampened meat production. The food price index averaged 172.2 points in March 2020, a decrease of 4.3 percent from February 2020, but 2.7 percent higher than in the corresponding period last year (Chart 3.16). The pronounced monthly decline in food prices is mainly due to demand-side contractions linked to the fall in oil prices and the effects of the Covid-19 pandemic as governments roll out restrictions designed to respond to the health crisis.

Chart 3.16: Food Price Index

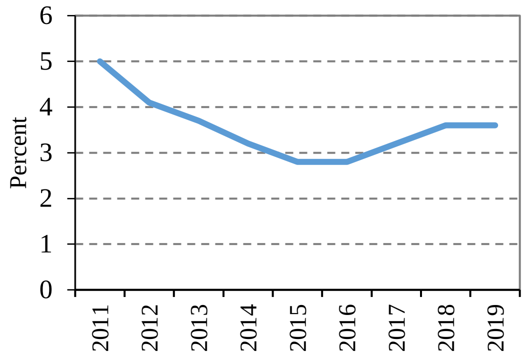


Source: Food and Agriculture Organisation

Global inflation unchanged in 2019

Global inflation was unchanged at 3.6 percent in 2018 and 2019 (Chart 3.17). For advanced economies, inflation decreased from 2 percent in 2018 to 1.4 percent in 2019. Conversely, inflation increased from 4.8 percent to 5 percent in emerging market economies in the same period. In South Africa, headline inflation averaged 4.1 percent in 2019, lower than the 4.6 percent in 2018. Inflation was 4.1 percent in March 2020, remaining within the South African Reserve Bank (SARB)'s target range of 3-6 percent.

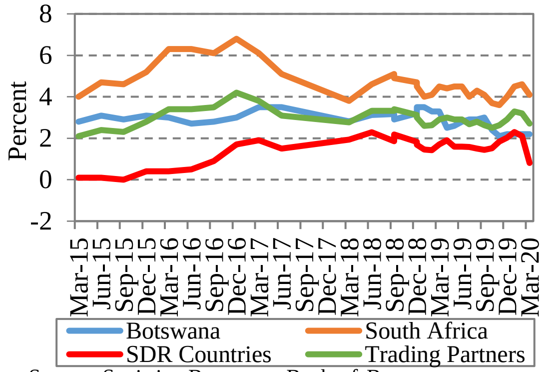
Chart 3.17: Global Inflation



Source: IMF April 2020 WEO

The average trade-weighted inflation for Botswana's trading partners decreased from 3.2 percent in February 2020 to 2.7 percent in March (Chart 3.18).

Chart 3.18: Botswana Inflation and International Inflation



Source: Statistics Botswana, Bank of Botswana, Statistics South Africa and Bloomberg

Mixed monetary policy developments

In the most recent policy decisions in advanced economies (Table 3.6), the European Central Bank (ECB) maintained the deposit rate, refinancing rate and lending rate at -0.50 percent, zero percent and 0.25 percent, respectively. With a view to support the banking system in the midst of Covid-19 pandemic, the ECB announced a package of balance sheet measures. The Committee announced additional longer-term refinancing operations (TLTROs) to provide immediate liquidity, as well as more favourable terms to TLTRO III to apply between June 2020 and June 2021. In addition to the temporary net asset purchases of €120 billion introduced on

March 12, 2020, the ECB announced a Pandemic Emergency Purchase Programme worth €750 billion until end of 2020, to help the economic bloc cope during devastating times of Covid-19.

The Federal Open Market Committee (FOMC) held two out of calendar meetings in less than two weeks during March 2020 and cumulatively reduced the US Federal Funds Rate from a range of 1.5 – 1.75 percent to 0 – 0.25 percent in March 2020. In addition, the FOMC announced quantitative easing purchases worth USD700 billion as well as dollar swap lines with other central banks. On March 23, 2020, the Federal Reserve announced it will buy unlimited quantities of US Treasury bonds and mortgage-backed securities, as well as increase corporate debt purchases. The Fed maintained the range for the Federal Funds Rate at 0 – 0.25 percent in April 2020, and issued a forward guidance that it will keep the policy rate at this new level until it is confident that the economy has weathered recent events and is on track to achieve its employment and price stability goals.

Similarly, the Bank of England (BoE) held two out of calendar meetings in March 2020, and cumulatively reduced the Bank Rate by 65 basis points to 0.1 percent. In addition, the BoE introduced a new Term Funding scheme with additional incentives for small and medium-sized enterprises, financed by the issuance of central bank reserves. Furthermore, the BoE increased its holdings of UK government and corporate bonds by £200 billion to a total of £645 billion. Broadly, the policy measures are aimed at sustaining businesses and consumer confidence, supporting businesses and households through the reduction in the cost of borrowing and improving the availability of finance.

The Bank of Japan (BoJ) eased monetary policy at the March 2020 meeting by pledging to buy risky assets such as exchange traded funds at an annual pace of around ¥12 trillion ($112.55 billion) and Japanese real estate trust funds (J-REIT) at ¥180 billion per year, which is double the amount it had pledged to buy before. This is aimed at curbing the rise of long-term yields amid mounting uncertainty caused by the outbreak of coronavirus. It, however, maintained its low policy rate of -0.1 percent. Moreover, the BoJ, Fed and ECB reported that they will closely monitor the impact of the Covid-19 on economic activity and pledged to take appropriate measures in response to the virus.

In emerging market economies, the South African Reserve Bank (SARB) reduced the repo rate by 100 basis points from 5.25 percent to 4.25 percent at an unscheduled meeting on April 14, 2020. This followed another reduction of 100 basis points in March, 2020. The SARB noted that a more prolonged lockdown and slower recovery would create downside risks to inflation and allowed further space for monetary policy to respond to the virus-induced demand shock to the economy. In the absence of severe and persistent currency and oil shocks, inflation was expected to be well contained, and remain below the midpoint of the target in 2020 and close to the midpoint in 2021. Similarly, the Bank of Brazil also cut the policy rate by 50 basis points to a record low of 3.75 percent in March 2020 to mitigate the effects of the Covid-19 virus which threatens to drive the economy into a recession.

The Central Bank of Russia (CBoR) cut the key rate by 50 basis points to 5.5 percent in April 2020, as the restrictive measures introduced to combat Covid-19 pandemic were expected to negatively impact economic activity. The CBoR indicated that it expected to further reduce the key rate. The Reserve Bank of India (RBI) reduced the policy rate by 75 basis points to 4.40 percent and also cut the Cash Reserve

Ratio[12] by 100 basis points to 3 percent at its emergency meeting on March 27, 2020 to counter the economic impact of Covid-19. On April 17, 2020, the RBI reduced the reverse repo rate by 25 basis points to 3.75 per cent to encourage banks to lend to the productive sectors of the economy. However, the policy rate was maintained at 4.40 percent.

On April 20, 2020, the People's Bank of China (PBoC) reduced the one-year Loan Prime Rate (LPR) by 20 basis points to 3.85 percent from 4.05 percent, to ease borrowing costs for companies and stimulate the economy severely affected by Covid-19 after it contracted in the first quarter of 2020 Moreover, the five year LPR, which influences the pricing of mortgages, was cut by 10 basis points to 4.65 precent. This followed the decision by the PBoC to cut the reserve requirement ratio (RRR) by 50-100 basis points on March 13, 2020, for banks that have met inclusive financing targets. The RRR for large banks is currently at 12.5 percent. The PBoC also injected 1.2 trillion yuan into the Chinese economy to ensure enough liquidity in the banking system and help provide a stable currency market. Moreover, the PBoC unexpectedly lowered the interest rates on reverse repurchase agreements by 10 basis points as an additional measure to relieve pressure on the economy from the rapidly spreading virus. On April 3, 2020, the PBoC cut the interest rate on excess reserves (IOER) from 0.72 percent to 0.35 percent. It announced that the RRR for smaller banks will be reduced by 100 basis points in two steps of 50 basis points each, with the first effective by April 15 and the second May 15, 2020.

Table 3.6: Monetary Policy Decisions

Central Bank	**Latest Meeting**	**Current Policy Rate (Percent)**	**Change from Previous Meeting**
Bank of Botswana	April 2020	4.25	Decreased by 0.50 percent
SARB	April 2020	4.25	Decreased by 1 percent
US Federal Reserve	April 2020	0 – 0.25	No change
BoE	March 2020	0.10	Decreased by cumulative 0.65 percent
ECB	March 2020	0.00	No change
BoJ	March 2020	-0.10	No change
PBoC	April 2020	3.85	Decreased by 0.20 percent
Brazil	March 2020	3.75	Decreased by 0.50 percent
India	April 2020	4.40	No change
Russia	April 2020	5.50	Decreased by 0.50 percent

[12] This is the amount of deposits lenders must set aside as reserves.

4. THE ECONOMIC AND POLICY OUTLOOK

4.1 Global economic prospects

The global GDP growth was revised downwards in the April 2020 WEO, on account of the ongoing unprecedented exogenous shock caused by the Covid-19 pandemic. The coronavirus has spread to more than 160 countries around the world, causing massive social and economic disruptions, as well as uncertainty in the trade, tourism and financial markets. The April 2020 WEO forecasts the global economy to contract by 3 percent in 2020, the worst economic downturn since the Great Depression. Economic activity is expected to rebound in 2021, with growth of 5.8 percent as economic activity normalises, buoyed by policy support. Regionally, in South Africa, apart from the national lockdown to contain Covid-19 and the country's credit rating being downgraded to 'junk' status by Moody's rating agency in March 2020, the growth outlook is projected to remain subdued due to the pre-existing negative impact of prolonged power supply shortages and waning business and investor sentiments. Regarding price developments, global inflation is forecast to decline from 3.6 percent in 2019 to 3 percent and 3.3 percent in 2020 and 2021, respectively, consistent with the anticipated decline in commodity prices amid subdued global demand.

Global economic outlook revised downwards

The April 2020 WEO revised the growth forecasts downwards, on account of the impact of Covid-19 on both supply and demand across the world. Global output is forecast to contract by 3 percent in 2020, markedly worse than during the 2008/09 financial crisis, and it is expected to be the worst economic crisis since the Great Depression of the 1930s. Economic activity is expected to rebound in 2021, with growth of 5.8 percent as economic activity normalises, buoyed by policy support. The projections are fraught with uncertainty, however, and dependent on, among others, the intensity and effectiveness of containment efforts, the extent of supply disruptions, the consequences of the tightening in global financial market conditions, shifts in spending patterns, confidence effects on households and businesses, as well as volatile commodity prices.

For advanced economies, output growth is forecast to decline by 6.1 percent in 2020, from 1.7 percent in 2019. Several of the advanced countries are experiencing wide-spread outbreaks, and the containment measures through lockdowns and curtailment of movement have impacted negatively on economic activity. Growth is projected to rebound to 4.5 percent in 2021. The 2020 projection is 7.7 percentage points lower than the January 2020 WEO Update, while for 2021 the forecast is 2.9 percentage points higher.

Output growth for US to decline

For the US, output is forecast to decline by 5.9 percent in 2020 before expanding to 4.7 percent in 2021 as the fiscal and monetary stimulus in place are expected to offset the detrimental effects of Covid-19. However, the growth forecasts are 7.9 percentage points lower for 2020 but 3 percentage points higher for 2021, relative to the January 2020 WEO Update.

Growth for the euro area to contract

In the euro area, economic activity is projected to contract by 7.5 percent in 2020 (8.8 percentage points lower than in the January 2020 WEO Update) from a growth of 1.2 percent in 2019 to a decline of 7.5

percent in 2020, before increasing to 4.7 percent in 2021. The 2020 growth forecasts for the economic bloc have been revised down significantly, with the top three economies, Germany, France and Italy among the countries with the largest infection rates. For Italy, growth was substantially revised downwards to a contraction of 9.1 percent for 2020, as the country became the new epicentre for the pandemic after China. Overall, the high level of uncertainty surrounding the virus and its duration is likely to drive the euro area into a recession.

Emerging markets GDP expansion projected to be lower

Growth in economic activity in emerging market and developing economies is projected at -1 percent for 2020; excluding China, the growth rate is forecast at -2.2 percent, from an estimated expansion of 3.7 percent in 2019. Growth for 2020 has been revised downwards by 5.4 percentage points. The revisions reflect the large anticipated domestic disruptions to economic activity due to Covid-19, and are influenced by the tightening in global financial conditions and a significant fall in commodity prices, which would severely impact on economic activity for commodity exporters. Economic growth is projected to increase by 6.6 percent in 2021.

The outbreak of the coronavirus has added pressure on the Chinese economy as it resulted in low industrial activity and exports, owing to the decrease in number of working days and lockdown, hence a downward revision of 4.8 percentage points to 1.2 percent for 2020, relative to the January 2020 WEO Update. In India, the downward revision of 3.9 percentage points to 1.9 percent growth in 2020 reflects the weaker outlook for growth in domestic demand than previously envisaged.

Growth in the South African economy to contract significantly

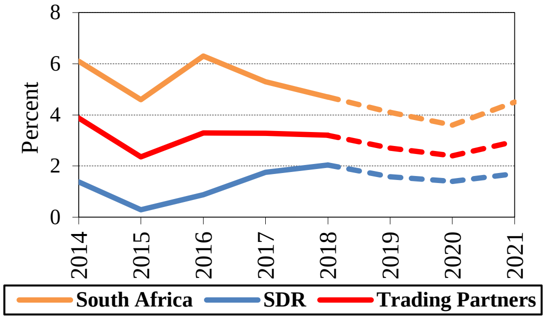
Growth prospects in South Africa are expected to be constrained by the pre-existing electricity supply constraints, and sluggish demand as a result of weaker business confidence, following the downgrade of the country's credit rating to 'junk' status by Moody's rating agency in March 2020. The country is also hard hit by the Covid-19 global pandemic with an increase in reported infected cases daily. This is expected to result in weaker demand for exports and domestic goods and services as well as disruptions to supply chains and normal business operations. Therefore, output is forecast to contract by 5.8 percent in 2020 but to pick up to growth of 4 percent in 2021, compared to 0.2 percent growth in 2019. Moreover, the lockdown to prevent the spread of Covid-19 is expected to further dent the economy that is already in a technical recession. Meanwhile, in April 2020, the SARB revised forecasts for GDP growth for 2020 and 2021 to -6.1 percent and 2.2 percent, from -0.2 percent and 1 percent, respectively, amid the Covid-19 pandemic.

Global inflation to be moderate

Globally, there are indications of emerging disinflationary pressures in 2020 emanating from slower global output growth against the backdrop of disruption in supply chains due to the pandemic that hampered both global economic activity and demand. In the short-term, supply chain bottlenecks are expected to put upward pressure on prices of some goods and services, but this could be broadly offset by weaker demand-side pressures underpinned by shorter working hours, cancellation of some scheduled purchases of goods and services and eminent lockdowns across the world. Global inflation is forecast at 3 percent and 3.3 percent in 2020 and 2021, respectively, from 3.6 percent in 2019. In advanced economies, disinflationary pressures are expected to mount, mainly due to the anticipated lower inflation in the US and euro area which are currently experiencing high cases of infections and deaths occasioned by Covid-19. Similarly, for emerging market economies, inflation is expected to decrease in 2020, consistent with slowdown in growth of final demand and lower commodity prices.

Meanwhile, South African inflation is forecast to average 3.6 percent in 2020, a downward revision by 0.2 percentage points from the previous forecast, mainly reflecting weaker domestic economic growth, as well as subdued global inflationary pressures. Overall, inflation is anticipated to remain within the SARB's target range but below the midpoint in 2020 (Chart 4.1).

Chart 4.1: South Africa and SDR Headline Inflation



Source: SARB and Bloomberg

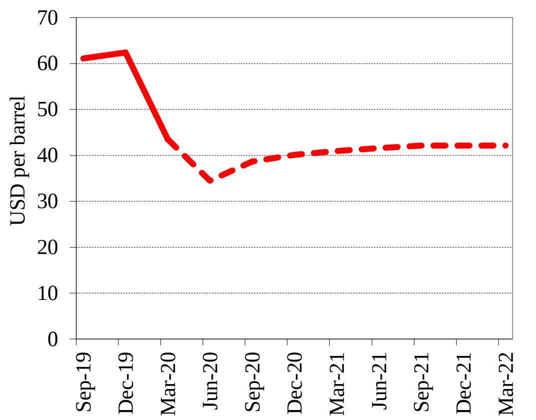
Diamond prices expected to fall

Global rough diamond prices are expected to trend downward in 2020, in the aftermath of the outbreak of Covid-19 which has significantly hit the world's diamond markets, with all trade fairs and majority of buying opportunities for the year cancelled. In addition, the increase in polished diamond inventories due to weak global demand and lack of funds resulting from late repayments by diamond traders in countries adversely affected by the pandemic is anticipated to add downward pressure on diamond prices. Likewise, polished diamond prices as well as diamond jewellery prices are expected to fall in 2020 as prospects for global end-consumer demand remain restrained. Risks to the global diamond industry are skewed to the downside, in the context of uncertainty surrounding the spread of the Covid-19 and proliferation of synthetic diamonds, as well as weak downstream sentiment related to macroeconomic and geopolitical factors. Lack of repayments by diamond traders in China and Hong Kong also poses massive liquidity risk to the diamond cutting and polishing industry.

International oil prices to decrease

International oil prices are projected to decrease sharply in the short to medium term (Chart 4.2), due to excess supply and weak global demand. International oil prices are expected to remain below USD35 per barrel for a while due to anticipated prolonged sluggish demand for oil due to work and travel lockdowns imposed by countries affected by Covid-19 as part of efforts to contain the spread of the pandemic. However, the agreement by major international oil producers to cut production is expected to curtail the fall in oil prices. Overall, developments in the international oil market imply downward pressure on domestic inflation.

Chart 4.2: International Oil Prices

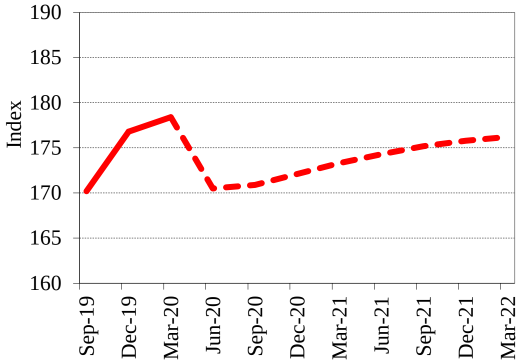


Source: Bloomberg

Global food prices to increase

Global food prices are trended upwards in the first quarter of 2020, driven by prices of vegetable oils, sugar and wheat (Chart 4.3). From a consumer basket perspective, prices surged temporarily supported by panic buying as the outbreak of Covid-19 persists across the globe. Nonetheless, food prices are expected to fall in the short-term owing to weaker demand-side pressures with exports projected to decrease as a result of interrupted trade of goods and services amidst uncertainty concerning the Covid-19 pandemic. International oil prices add to the anticipated fall in food production costs and hence food prices beyond the first quarter of 2020. Overall, there is potential modest downward pressure from food prices on domestic inflation.

Chart 4.3: International Food Prices FAO Index



Source: Bloomberg

4.2 Outlook for domestic economic activity

GDP growth is projected to be significantly lower than the earlier projection of 4.4 percent in 2020 mainly due to the negative impact of Covid-19. However, the prevailing accommodative monetary conditions, improvements in water and electricity supply, reforms to further improve the business environment and government interventions against Covid-19, including the envisaged economic stimulus package, would generally be positive for economic activity in the medium term, although the economy would continue to operate below its potential.

Lower growth expected in domestic output

Before the outbreak of Covid-19, real GDP was projected to expand by 4.4 percent in 2020, driven mainly by the expected recovery of mining activity and anticipated improvement in global output. It was also anticipated that performance of the non-mining sectors would improve, underpinned by, among others, the accommodative monetary conditions in the domestic economy, expected growth in government expenditure in the 2020/21 fiscal year, improvements in electricity and water supply, as well as the reforms to further improve the business environment.

However, given the downside risks to global economic activity, mainly emanating from the outbreak of Covid-19, global demand and commodity prices (including for rough diamonds) have fallen, thereby dampening future economic performance. In line with these anticipated global developments, growth forecasts for the domestic economy by both the Ministry of Finance and Economic Development (MFED) and the IMF have been significantly revised downwards to reflect the adverse impact of Covid-19. For Botswana, this pandemic poses added uncertainty and challenges given Botswana's high vulnerability to external shocks, notably, diamond production and demand, tourism and possible disruption of imported supplies either from South Africa or through South African ports of entry. Therefore, the MFED projects that GDP will decline by 13.1 percent in 2020 and rebound to a 3.9 percent growth in 2021. Also, in the April 2020 World Economic Outlook, the IMF forecast GDP for Botswana to fall by 5.4 percent and rebound to 6.8 percent in 2021. These wide range of forecasts are to be expected given the uncertainty of the duration and depth of the Covid-19 related economic disruptions. Notwithstanding, the projected decline in output is attributed to a sharp contraction in major sectors such as mining, trade, hotels and restaurants, manufacturing, social and personal services, as well as transport and communications. Box 4 outlines Bank of Botswana's response to Covid-19.

The Bank's March 2020 Business Expectations Survey indicates a deterioration in the level of confidence among businesses in 2020, largely due to the anticipated negative impact of Covid-19 on business operations. Therefore, non-mining activity is anticipated to decline in the short term and continue operating below potential into the medium term.

Box 4: Bank of Botswana's response to the impact of Covid-19 pandemic

Botswana confirmed its first three-imported-cases of Covid-19 on March 31, 2020. As at May 3, 2020, twenty-three cases (nine local transmissions and one death) had been reported in the country. To curb the spread of the disease, the country was put on a 28-day lockdown (extreme social distancing) effective from midnight of April 2, 2020, with movement outside the home only restricted to essential goods and service providers. On April 9, 2020, Parliament approved His Excellency the President's request for a six-month state of emergency to allow the country to adequately respond to the threat posed by Covid-19. The lockdown was extended to May 7, 2020, after which, the current extreme social distancing regulations will be reviewed.

As an open economy that is integrated with regional global economies, Botswana is affected through several channels, among others, local infections; weaker global demand affecting exports (diamonds and tourism, for example); disruption to global supply chains affecting local production and project execution; and disruptions caused by containment and mitigation measures imposed by Government. Other channels include the impact of disruption of economic activity on the banking system and likely reduction in fiscal and external buffers; as well as the weak performance of, and panic, in the global markets that, invariably, will negatively impact on the nation's official foreign exchange reserves. Overall, IMF's April 2020 World Economic Outlook estimates that the domestic economy will contract by 5.4 percent in 2020, before rebounding to 6.8 percent in 2021, while the MFED projects a sharp deterioration, of a 13.1 percent contraction and a modest recovery of 3.9 percent growth in 2021.

Bank of Botswana (the Bank) has undertaken the following measures to alleviate the adverse impact of Covid-19 on the Botswana economy:

- The Bank will maintain uninterrupted supply and availability of clean banknotes and coin, as well as banking services, primarily to Government and commercial banks.

- With a view to support the banking system, the Bank offered capital relief and support for commercial banks to enable them to satisfy capital requirements and address liquidity challenges as they continue to support economic activity under conditions of possible increase in credit defaults and impairments as well as the need for additional lending. In this regard:

  - ❖ The prudential capital adequacy ratio for commercial banks operating in Botswana has been reduced from 15 percent to 12.5 percent; and
  - ❖ To alleviate any possible pressure on the commercial banks and extend potential additional sources of liquidity, the following measures have been introduced:
    - ▪ The cost of accessing overnight funding by licensed commercial banks from the Bank's Credit Facility is accessed at the prevailing Bank Rate (currently 4.25 percent) without the punitive 6 percentage points above the Bank Rate;
    - ▪ Repo facilities currently available only on an overnight basis will be offered against eligible securities with maturities of up to 92 days; and
    - ▪ Subject to completing regulations and arrangements relating to valuation and custody, the collateral pool for borrowing by licensed commercial banks from the Bank will be extended to include corporate bonds listed and traded on the Botswana Stock Exchange.
    - ▪ In addition, consistent with provisions of the Electronic Payments Services Regulations, the limits on mobile money transactions have been raised as follows: maximum single transaction, from P5 000 to P10 000; maximum daily transaction, from P10 000 to P15 000; and maximum monthly aggregate, from P20 000 to P30 000.

Given that the full extent of economic and financial disruption from Covid-19 is yet to be established, the measures currently expended by the Bank will continue to be revised as the need arises.

Source: Bank of Botswana

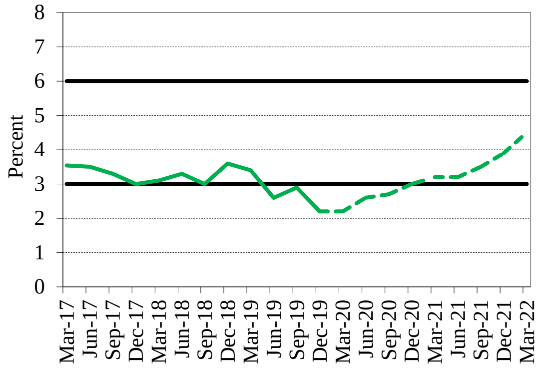
4.3 Monetary policy and the inflation outlook

Inflation in Botswana is forecast to remain below the Bank's 3 - 6 percent medium term objective range and revert to within the desired objective range in the fourth quarter of 2020. Compared to the February 2020 forecast, the current forecast shows a lower inflation projection profile, reflecting the substantial downward revision of forecasts for domestic output growth, trading partner inflation and international commodity prices amid the Covid-19 pandemic. The overall risks to the inflation outlook are on the downside. Downside risks to the inflation outlook relate to weak domestic and global economic activity, and the fall in international commodity prices. These risks are moderated by the potential increase in international commodity prices beyond current forecasts, as well as the anticipated supply constraints due to travel restrictions and lockdowns.

Inflation projected to revert to within the objective range in the fourth quarter of 2020

Inflation is forecast to remain below the lower bound of the Bank's 3 - 6 percent objective range in the short term, mainly due to the disinflationary pressures anticipated from the effects of the Covid-19 pandemic on both the domestic and global prospective economic developments (Chart 4.4).

Chart 4.4: Botswana Headline Inflation Forecast



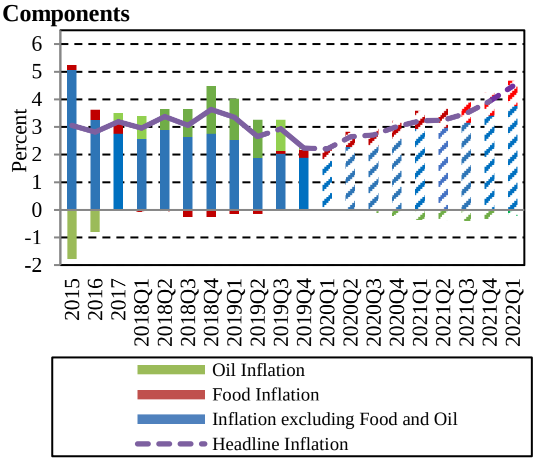
Source: Bank of Botswana

It is anticipated that the stringent measures put in place by governments across the world to curb the spread of the Covid-19 pandemic, such as travel restrictions and lockdowns, will significantly suppress aggregate demand, economic growth and, hence, dampen inflation in trading partner countries, as well as in Botswana. However, short-term domestic inflationary pressures are expected to emanate from the implementation of a new annual downward rate of crawl of 2.87 percent with effect from May 1, 2020, and the recent upward adjustments in the electricity tariffs and DStv subscriptions. This is, however, expected to be partially offset by the downward adjustment in domestic fuel prices in the same period. As a result, inflation is projected to revert to within the objective range in the fourth quarter of 2020. Meanwhile, according to the March 2020 BES, the business community expect inflation to be within the objective range in 2020.

Core inflation to increase in the short to medium term

Inflation excluding food and fuel prices is forecast to rise in the near term, mainly driven by the upward adjustment in the electricity tariffs and DStv subscription charges in the second quarter of 2020. Core inflation is also expected to increase going into the medium term, mainly due to the expected improvement of the non-mining output growth (Chart 4.5).

Chart 4.5: Headline Inflation and its Components

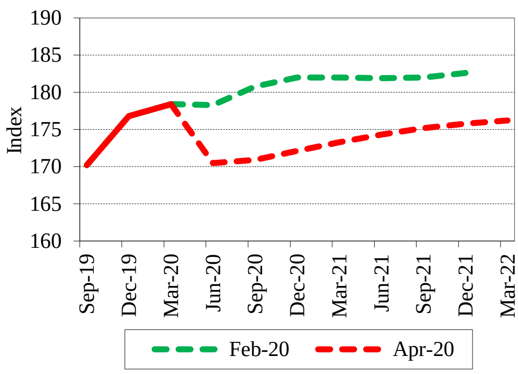


Source: Bank of Botswana

International food prices revised downwards

Compared to the February 2020 forecast, international food prices have been revised downwards in the short to medium term (Chart 4.6). The downward revision is mainly due to the decrease in international oil prices, as oil is a major input in the production of food commodities.

Chart 4.6: International Food Prices FAO Index

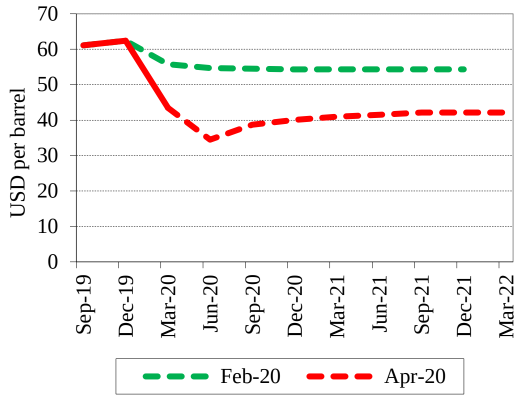


Source: Bloomberg

International oil prices revised downwards

Relative to the February 2020 projection, international oil prices have been significantly revised downwards in the short to medium term (Chart 4.7). The downward revision in prices mainly reflects the decline in demand for oil due to work and travel restrictions imposed across the world as part of efforts to contain the spread of Covid-19. The downward revision in international oil prices is also a result of the price war between Russia and Saudi Arabia following the disagreement to extend oil production cuts at the March 2020 meeting.

Chart 4.7: International Oil Prices



Source: Bloomberg

Overall, developments with respect to international oil and food prices imply downward pressures on domestic inflation.

Inflation forecast revised downwards

The April 2020 inflation forecast has been revised downwards compared to the February 2020 forecast, reflecting the substantial downward revision in forecasts for domestic output growth, international commodity prices and trading partner inflation, mainly due to the Covid-19 pandemic.

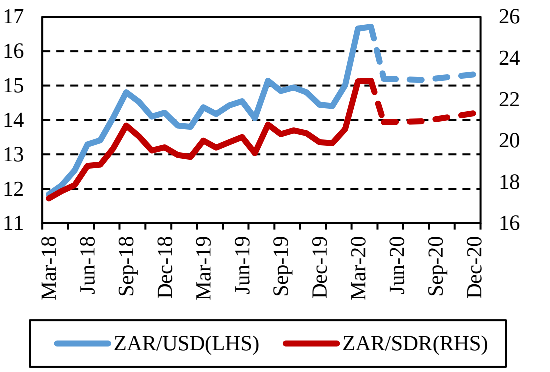
Exchange rate movements

The Pula exchange rate is determined by the performance of the Pula basket currencies and the rate of crawl. Once the basket composition and the rate of crawl (based on inflation differentials) have been determined, the daily changes in the value of the Pula against other currencies are a result of movements in the cross rates of the rand and the SDR constituent currencies against each other, and their relative weights in the composite currency basket.

The South African rand is expected to depreciate significantly against major currencies in the next three quarters (Chart 4.8), as global factors are expected to weigh on investor sentiment for emerging markets currencies. The adverse economic impact of the global spread of Covid-19, as well as the current oil market crash[13] continue to weigh on the demand for riskier emerging markets assets (of which the rand is part). Investors' scepticism on the ability of the government to efficiently deal with the outbreak of the virus in South Africa, sluggish economy and structural reforms implementation as well as South Africa's debt problems (partly due to the cash-strapped power utility, Eskom) continue to put pressure on the South African rand.

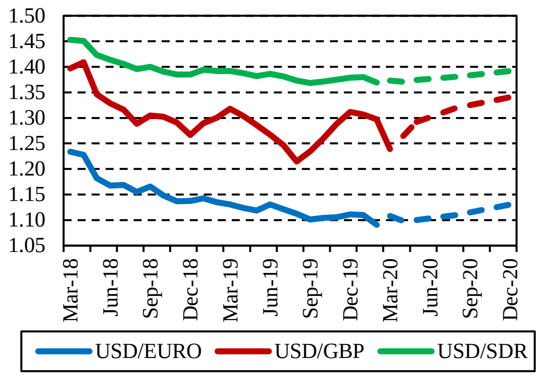
In response to the threat of a global recession posed by the spread of Covid-19, central banks across the world, including the South African Reserve Bank (SARB) have engaged in providing further monetary accomodation, as well as providing liquidity support to ensure smooth functioning of markets. However, monetary policy easing in developed economies is not expected to benefit the South African rand against the US dollar, since the domestic economic outlook remains fragile.

Chart 4.8: ZAR against USD and SDR



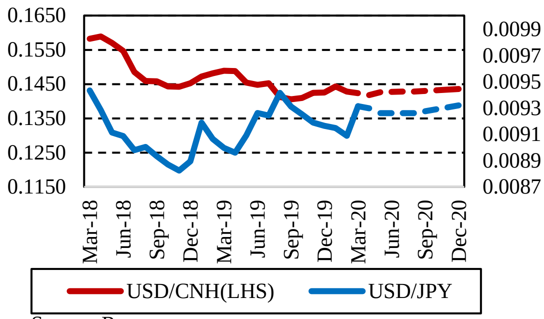
Source: Reuters

Chart 4.9A: Exchange Rates against USD



Source: Reuters

Chart 4.9B: Exchange Rates against the USD



Source: Reuters

The US dollar is expected to appreciate against major international currencies in the next three quarters (Chart 4.9A and Chart 4.9B), due to its safe-haven status during times of turmoil. Global uncertainty and market volatilty due to the impact of Covid-19 on the global economy tend to influence investors to hold the world's most liquid currency, the US dollar. However, once global growth sentiment improves, zero rates and quantitative easing would weaken the dollar through increased inflation expectations and capital outflows.

The British pound is expected to depreciate against the US dollar on the back of deteriorating risk sentiment. Following Brexit,[14] Britain has been increasingly viewed as a riskier economy. Therefore, the

[13]. This was triggered by a price war between Saudi Arabia and Russia, as Russia rejected a recommendation for further oil production cuts.

[14] Britain left the EU bloc on January 31, 2020.

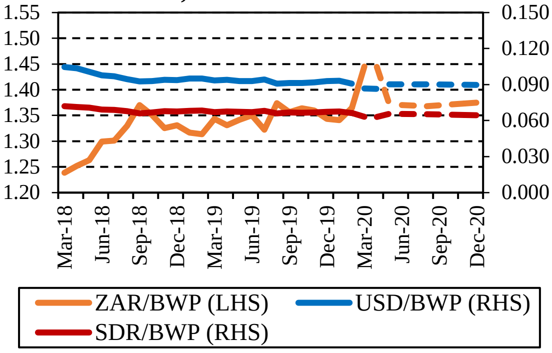
pound tends to depreciate significantly in periods of elevated price volatility. Concerns about the spread of Covid-19 and increased illiquidity in the government bonds market, weigh on the forecast. However, increased monetary stimulus and supportive fiscal policy are expected to change market sentiment.[15] Meanwhile, the euro is expected to depreciate against the US dollar, despite its renewed asset purchase programme, due to investors' risk aversion and the unprecedented amount of uncertainty caused by the pandemic.

The Japanese yen is expected to be relatively stable against the US dollar due to its safe-haven status. However, measures taken by the Fed and the Bank of Japan to cushion the effects of the pandemic, as well as Japan's negative economic outlook are likely to affect this forecast.

The Chinese renminbi is expected to depreciate against the US dollar in the next three quarters (Chart 4.9B) as Covid-19 continue to dampen business activity in China. The pace of the renminbi's depreciation against the US dollar is expected to be slowed by the PBoC's daily reference rate.[16]

Overall, forecast movements of the SDR constituent currencies would result in the slight appreciation of the SDR against the US dollar (Chart 4.9A). The Pula is expected to depreciate against the SDR currencies, however, at a slower rate compared to the South African rand depreciation, and therefore, lead to an appreciation[17] of the Pula against the South African rand (Chart 4.10). The expected appreciation of the Pula against the South African rand will help moderate imported inflation.

Chart 4.10: BWP Exchange rates against ZAR, USD and SDR



Source: Reuters and BoB calculations

Risks on the downside

The overall risks to the inflation outlook are on the downside, reflective of weak domestic and global economic activity, due to the ongoing Covid-19 pandemic and the fall in international commodity prices. These risks are moderated by the potential increase in international commodity prices beyond current forecasts, as well as the anticipated supply constraints due to travel restrictions and lockdowns.

[15] Bank of England increased its bond-buying program and reduced the interest rate by 15 basis points to 0.1 percent on March 19, 2020. Moreover, the UK government pledged to pay workers' wages up to 80 percent.

[16] The renminbi is allowed to trade up to 2 percent above or below the PBoC's reference rate, which was set at 6.98 in February 2020.

[17] The movement of the Pula against the SDR constituent currencies largely reflects the performance of the South African rand against the SDR constituent currencies.

5. APRIL 2020 MONETARY POLICY COMMITTEE DECISION

At the meeting held on April 30, 2020, the MPC of the Bank of Botswana decided to reduce the Bank Rate by 50 basis points from 4.75 percent to 4.25 percent and the PRR from 5 percent to 2.5 percent. Inflation was unchanged for the fourth consecutive month at 2.2 percent in March 2020, remaining below the lower bound of the Bank's desired medium-term objective range of 3 – 6 percent. Inflation is forecast to revert to within the objective range in the fourth quarter of 2020. This represents a significant downward revision compared to forecasts contained in the February 2020 Monetary Policy Statement.

The Covid-19 pandemic and consequent containment measures have severely curtailed economic activity globally and domestically as production, supply chains, project implementation and provision of goods and services are halted. Similarly, consumption and spending are disrupted, hence domestic demand pressures and foreign prices remain subdued. Consequently, overall risks to the inflation outlook are skewed to the downside, taking into account weak domestic and global economic activity and likely decrease in international commodity prices. However, inflation may rise above current forecasts if international commodity prices increase beyond current projections and in the event of upward price pressures occasioned by supply constraints due to travel restrictions and lockdowns.

Real GDP grew by 3 percent in 2019, compared to a faster growth of 4.5 percent in 2018. The lower increase in output was mainly attributable to acontraction in mining output as well as a deceleration in non-mining GDP growth. Mining output contracted by 3.9 percent in 2019, compared to a faster increase of 7.9 percent in 2018, mainly due to weaker performance of the diamond, soda ash, copper and coal sub-sectors. Non-mining GDP grew by 3.8 percent in 2019, compared to 4.1 percent in 2018. The slower expansion in non-mining GDP was mainly due to a deceleration in output growth of the manufacturing, construction, transport and communications, and social and personal services sectors.

Projections by both the Ministry of Finance and Economic Development (MFED) and the IMF suggest a sharp deterioration in economic growth for Botswana in 2020. In the April 2020 World Economic Outlook, the IMF forecast GDP to fall by 5.4 percent this year, before rebounding to 6.8 percent in 2021, while the MFED estimates that the economy will contract by 13.1 percent, and rebound to a 3.9 percent growth in 2021. This wide range of forecasts attest to the challenges of making forward projections where there is uncertainty about the duration of constrained economic activity, the resultant damage to productive capacity, as well as the speed of resumption of production and pace of recovery in demand.

Broadly, the contraction in GDP reflects the substantial curtailment of economic activity due to the necessary global and domestic measures implemented to contain the spread of Covid-19 and safeguard human life. The resultant decrease in global demand and disruption in supply chains, as well as curtailed economic activity locally, has affected several sources of economic growth for Botswana. Notably, these include exports such as minerals and tourism as well as non-food retail economic activity and, also, disruption of the harvest season during a relatively good year when farmers were, in general, expecting a bumper harvest of various crops, especially cereals. Furthermore, unlike in the 2008/9 Global Financial Crisis, the exogenous shock to the economy occurs amid weakening of the country's fiscal and external buffers, characterised by government fiscal deficits for three consecutive financial years and gradual decline in foreign exchange reserves from 18.3 months of import cover in 2015 (P84.9 billion) to the current level of P68.9 billion as at end of January 2020 (or 13.3 months of import cover).

The global backdrop is that the world economy is forecast to contract by 3 percent in 2020. This is worse than the contraction experienced during the 2008/09 global financial crisis, and the fallout from the Covid-19 crisis is projected to surpass that of the Great Depression of the 1930s. Nevertheless, economic activity is expected to rebound in 2021, with global growth estimated at 5.8 percent, anchored by unprecedented policy and resource support by individual countries and multilateral institutions. However, the recovery projections are fraught with uncertainty with respect to several critical factors, namely, the intensity and effectiveness of containment efforts; the extent of supply disruptions; fiscal and market financing constraints; shifts in spending patterns; trends in commodity prices; and, ultimately, business and consumer confidence. A similar pattern of developments pertains with regard to the rest of the Sub-Saharan Africa region.

The MPC, however, recognised that the short-term adverse developments in the domestic economy occur against a potentially supportive environment including accommodative monetary conditions; improvements in the provision of utilities; reforms to further improve the business environment; concerted efforts by government to mitigate the impact of Covid-19; and a prospective economic stimulus package. These would generally be positive for economic activity in the medium term. Even then, it is projected that the economy will operate below full capacity in both the short and medium term, and, therefore not creating any inflationary pressures, going forward.

Therefore, the current state of the economy and the outlook for both domestic and external economic activity provide scope for easing monetary policy to support domestic economic activity. Accordingly, the MPC decided to reduce the Bank Rate by 50 basis points to 4.25 percent. Commercial banks are required to make the necessary interest rate adjustments with immediate effect to reflect this policy decision.

The MPC has also decided to reduce the PRR from 5 percent to 2.5 percent, effective May 13, 2020. This is expected to inject liquidity of approximately P1.6 billion into the banking system, which should allow commercial banks to be unconstrained in performing the necessary financial intermediation to support economic activity.

Furthermore, as decided by His Excellency the President, on advice by the Honourable Minister of Finance and Economic Development following consultation with the Bank, the Bank will implement a new annual downward rate of crawl of 2.87 percent with effect from May 1, 2020, representing a change from the current 1.51 percent. This is complementary to the reduction in the Bank Rate and contributes to further easing of real monetary conditions in the economy.

Other measures already implemented by the Bank, which form part of the monetary policy and regulatory response to the Covid-19 economic fallout are:

(a) the cost of accessing overnight funding by licensed banks from the Bank of Botswana Credit Facility is provided at the prevailing Bank Rate without the punitive 6 percentage points above the Bank Rate that prevailed before;

(b) repo facilities that were available only on overnight basis are now offered against eligible securities with maturity of up to 92 days;

(c) the collateral pool for borrowing by licensed commercial banks from the Bank of Botswana has been extended to include all corporate bonds listed and traded on the Botswana Stock Exchange. This is, however, subject to completing regulations and arrangements relating to valuation (haircuts), custody and settlement in central bank money;

(d) the minimum capital adequacy ratio for banks was reduced from 15 percent to 12.5 percent; this should provide capital relief amounting to approximately P326 million for the entire banking industry; and that

(e) the Bank will also generally exercise regulatory forbearance in relation to assessment of non-performing loans and determination of expected credit losses, for regulatory and compliance purposes.

Commercial banks have offered a package of discretionary cashflow relief to support business and retail customers that are negatively affected by the Covid-19 pandemic. These include loan repayment holidays for an initial period of three months, restructuring of credit and other repayment terms for various loan and credit facilities and, also, free or discounted prices for digital banking channels. However, the deferral of loan repayments is only intended to provide relief to bank customers temporarily experiencing cash flow constraints during these difficult times; it should not be regarded as debt forgiveness. Consistent with the contractual obligations of the borrower, both the principal amount and interest would remain outstanding and interest will continue to accrue or accumulate increasing the outstanding amount. The Bank has initiated the collection of related data that should be available to inform the potentially evolving policy posture and the regulatory responses as may be necessary.

In summary, the policy decisions and liquidity support measures should, individually and combined, be supportive of the economy in terms of:

(a) easing borrowing costs in the economy and provide a sound springboard for future recovery;

(b) sustaining, albeit for a short period, the cash flow position and balance sheets of both businesses and households in these difficult times;

(c) facilitating unconstrained banking system support for economic activity;

(d) enhance international competitiveness of the domestic industries; and

(e) foster greater impact and traction of any economic stimulus initiatives.

Notwithstanding, the implementation of the foregoing measures, improving total factor productivity, structural reforms, export competitiveness of domestically produced goods and services as well as governance arrangements remain paramount in promoting sustainable and inclusive economic growth.

The Bank remains committed to its objective of monetary and financial stability and will respond timely to deviations of inflation from the objective range in support of durable economic development.

The remaining MPC meetings for 2020 are scheduled as follows:

June 18, 2020
August 20, 2020
October 8, 2020
December 3, 2020