MONETARY POLICY REPORT

AUGUST 2018

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 bank 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 formulation and implementation of monetary policy. It provides a comprehensive, forward-looking framework for policy formulation by the MPC and serves as a basis for policy decisions. It also 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 October meetings of the Monetary Policy Committee (MPC). It presents a 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 Bank's actions and Monetary Policy Reports promote 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 sustainable 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. The Ministry of Finance and Economic Development, in consultation with the Bank, makes a recommendation, for consideration and approval by His Excellency, The President, 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. In addition, the Bank uses short-term interest rates to steer the economy through the business cycle, thus helping to maintain price stability.

In evaluating policy options, the Bank pursues a forward-looking monetary policy with a central role for a medium-term inflation forecast. The Bank changes policy whenever required, 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. This is because monetary policy affects price developments with considerable lags. 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 consist primarily of auctioning Bank of Botswana Certificates and engaging in Repo/Reverse Repo transactions with commercial banks (primary dealers), as well as the Primary Reserve Requirement Ratio.

1.3 Decision-making process

Monetary policy is implemented in line with the decisions of the MPC. The current MPC comprises: the Governor; the two Deputy Governors; General Manager responsible for banking and currency operations; Director of Research and Financial Stability Department and the two Deputy Directors of the Department responsible for monetary policy and financial stability, respectively; Director and Deputy Director of the Financial Markets Department responsible for the domestic market; and Director of the Banking Supervision Department. The MPC holds six pre-scheduled meetings per year, at which a decision is made on the monetary policy stance. However, the Committee can meet more often if need be. Prior to the commencement of the year, the dates for the MPC meetings are announced for the year ahead. The pre-announcement of MPC meeting dates is in line with the increasing trend, among central banks, to integrate transparency into the conduct of monetary policy.

1.4 Announcement of the monetary policy decision

The monetary policy decision is announced through a statement issued 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. In addition, the Governor holds a Press Briefing to allow for interaction with members of the media and promote understanding of the Bank's economic analysis and policy stance.

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 Bank's policy choices for the ensuing year. Subsequently, the MPR is produced for the April, August and October 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

Monetary policy has so far in 2018 been implemented in the context of a favourable medium term inflation outlook, associated with moderate domestic demand resulting from restrained increase in personal incomes and expected modest increase in foreign prices. Hence, the Bank Rate was maintained at 5 percent at the August 2018 MPC meeting. The last policy change was in October 2017, when the Bank Rate was reduced by 50 basis points from 5.5 percent to 5 percent.

Upside risks to the inflation outlook relate to any substantial upward adjustment in administered prices, international oil and food prices, as well as government levies and taxes, beyond current forecasts.

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

Headline inflation averaged 3.3 percent in the second quarter of 2018, a decline from an average of 3.5 percent in the second quarter of 2017, reflecting the reduction in food inflation. Headline inflation was 3.1 percent in July 2018. Domestic inflation is expected to remain within the 3 – 6 percent objective range in the short to medium term.

Gross Domestic Product (GDP) grew by 3.3 percent in the twelve months to March 2018 compared to a growth of 4 percent in the corresponding period ending in March 2017. Output growth is projected to be higher in the short to medium term as a result of the recovery in the mining sector, in line with the positive global economic prospects. Furthermore, the projected accommodative domestic monetary conditions and expansion in government expenditure in the 2018/19 fiscal year, as well as stability in water and electricity supply, are expected to add impetus to economic activity in the non-mining sectors, hence have a positive impact on overall economic growth. However, output is projected to remain below potential in the forecast horizon, mainly on account of structural constraints to a higher level of economic activity.

Annual growth in commercial bank credit accelerated to 7.6 percent in the second quarter of 2018 from 4.1 percent in the corresponding period in 2017, reflecting, in part, the utilisation of credit facilities by diamond cutting and polishing companies.

At the end of June 2018, foreign exchange reserves were P74.3 billion, a decrease from P74.7 billion in June 2017, and were equivalent to 18.3 months of import cover of goods and services. The decrease in the foreign exchange reserves mainly reflected the net foreign exchange outflows. The current account continues to record a surplus, mainly driven by the Southern African Customs Union (SACU) receipts. However, the surplus in the first quarter of 2018 was lower compared to that recorded in the corresponding quarter in 2017 due to the decrease in the value of diamond exports.

The nominal effective exchange rate (NEER) of the Pula depreciated by 0.06 percent in the twelve months to July 2018, consistent with the transition from 0.26 percent upward annual rate of crawl in 2017 to a 0.3 percent downward annual rate of crawl effective January 2018. The Pula appreciated against the South African rand, but depreciated against the SDR in the twelve months to July 2018. The depreciation of the Pula against SDR currencies (except the Chinese renminbi) reflects the performance of the rand against the SDR currencies. In the year to June 2018, the real effective exchange rate (REER) was virtually stable (0.21 percent depreciation), given the marginal inflation differential between Botswana and the trading partner countries, as well as the downward crawl of the NEER.

The faster pace of global economic expansion in the first quarter of 2018 provided a favourable backdrop for domestic economic activity. Economic performance strengthened in the USA, mainly driven by improved domestic demand and higher consumer and business confidence. In the euro zone, economic growth slowed in the first quarter of 2018, amid concerns about trade war with the US. Growth in the UK was modest, due to slowing business investment. Economic activity continues to improve in the emerging market economies, supported by favourable domestic financing conditions, the recovery in demand and world trade growth, including an increase in commodity prices. Growth in South Africa was subdued, as GDP contracted by 2.2 percent in the first quarter of 2018, undermined by the muted domestic demand.

The global rough diamond price index increased in the second quarter of 2018 as demand improved. The polished diamond price index also increased in the same period, due to better world economic prospects and positive consumer sentiment. International oil prices remained above USD70 per barrel in the second quarter of 2018. OPEC (and its non-OPEC partners) have agreed to increase oil production from July 2018 in order to address rising oil prices influenced by US sanctions against Iran and increased demand. Meanwhile, the United Nation's Food and Agriculture Organisation (FAO) index indicates that international food prices increased in the second quarter of 2018, as prices of all food groups increased, except dairy products.

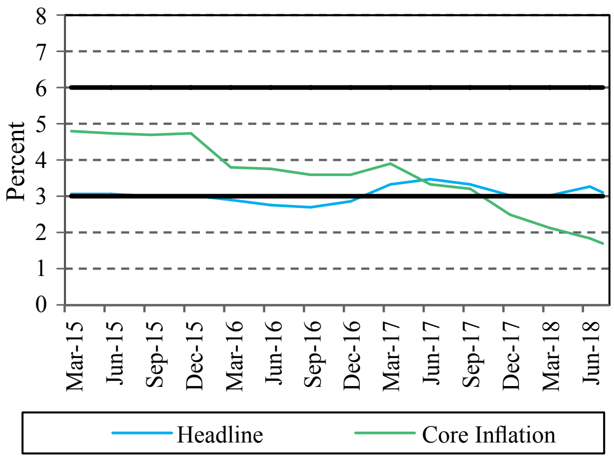
3. RECENT ECONOMIC DEVELOPMENTS

3.1 Recent inflation environment

Headline inflation decreases marginally in the second quarter of 2018

Headline inflation averaged 3.3 percent in the second quarter of 2018 and was lower than the 3.5 percent in the second quarter of 2017 (Chart 3.1), mainly reflecting lower food inflation. Headline inflation was 3.1 percent in July 2018 (Table 3.1). Inflation remains low and stable, and within the Bank's medium-term objective range of 3 – 6 percent, reflecting, in part, subdued domestic demand, the relative strength of the Pula against the rand and the modest increase in prices of imported goods. However, there is an upward momentum for the international oil prices that could exert modest upward pressure on domestic inflation. Moreover, related domestic factors (including delayed adjustments of fuel prices to match international oil price movements) could add to inflation in the short term.

Chart 3.1: Botswana Headliine and Core Inflation

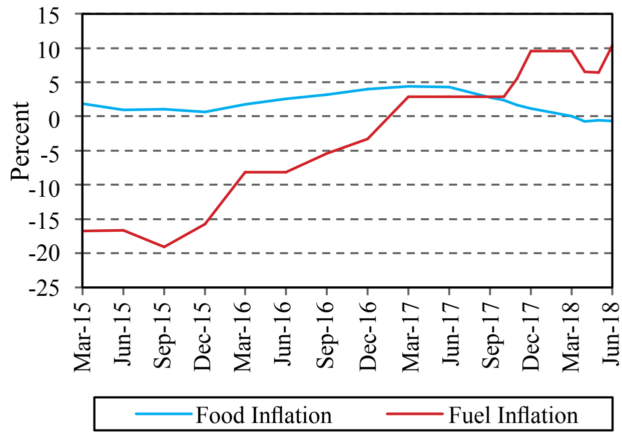


Source: Statistics Botswana
Note: Core Inflation is headline inflation excluding administered prices

Core inflation measures diverge

Inflation excluding administered prices (CPIXA) averaged 1.8 percent in the second quarter of 2018 compared to 3.3 percent in the second quarter of 2017, while the trimmed mean inflation (CPITM) increased to 3.1 percent from 3.0 percent in the same period. Inflation excluding food and fuel (CPIXFF) averaged 3.7 percent in the second quarter of 2018, higher than the 3.4 percent in the corresponding quarter in 2017. The divergence in the core inflation measures reflect the impact of food prices, which fell substantially between the second quarter of 2017 and 2018.

Chart 3.2: Food and Fuel Inflation



Source: Statistics Botswana and Bank of Botswana calculations

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

Category of commodities	Basket Weights	Jul 2018	Q2 2018	Q2 2017
Miscellaneous goods and services	10.6	7.6	8.2	2.2
Transport	20.7	7.7	6.7	1.6
Education	3.3	5.4	5.5	4.1
Restaurants and hotels	2.8	3.6	3.6	3.7
Housing, water, electricity, gas and other fuels	14.9	3.5	3.4	6.5
Clothing and footwear	6.3	2.0	2.1	3.2
Furnishing, household equipment and routine maintenance	6.4	2.0	2.1	3.6
Recreation and culture	2.9	2.0	2.0	2.4
Health	3.6	0.8	1.2	2.2
Alcoholic beverages and tobacco	7.8	0.8	0.6	5.0
Food and non-alcoholic beverages	16.5	-1.1	-0.4	4.1
Communication	4.3	-8.2	-1.9	0.2
Annual Inflation (All items)	**100.0**	**3.1**	**3.3**	**3.5**
CPITM		3.1	3.1	3.0
CPIXA		1.7	1.8	3.3
CPIXFF		3.3	3.7	3.4

Source: Statistics Botswana and Bank of Botswana calculations

Box 1: Core Inflation

Headline inflation measures the change in the overall consumer price index (CPI), which represents the cost of living of a representative household in Botswana relative to a chosen/specified base period. The current base period is September 2016. The index is constructed by Statistics Botswana based on regular monthly surveys of prices of goods and services across the country. In principle, the changes in consumer prices (inflation) are a result of demand and supply dynamics.

The CPI includes several components that are beyond the control of monetary policy. Among these are administered prices, including fuel prices, which are determined by international oil prices and through government policy and taxes. Moreover, food prices may be severely affected by adverse or favourable weather conditions. Despite their significant contribution to overall inflation, such temporary changes cannot be influenced to any great extent by monetary policy. Thus, a measure of inflation that is less affected by such changes, referred to as core inflation, is used by the Bank to identify underlying price dynamics and avoid responding to temporary shocks that dissipate autonomously.

Core inflation is typically a subset of the headline measure and is deemed to represent the underlying trend or the persistent component of price developments. It is, thus, considered to be a good predictor of future inflation. As such, core inflation is less prone to short-run volatility than the headline inflation. By reporting core inflation, along with headline inflation, the public is better informed that temporary deviations in inflation from the objective range do not reflect reduced commitment by the Bank to the objective of maintaining price stability. There are several methods used in deriving core inflation measures. The key measure used by the Bank is headline inflation excluding food and fuel prices. Other measures are by exclusion of administered prices and the trimmed mean (see Table 3.2), which are estimated and published by Statistics Botswana. It must, however, be emphasised that no single inflation measure forms the basis for policy decisions as these are based on the overall context of the prevailing and expected economic environment.

Table 3.2: Measures of Core Inflation

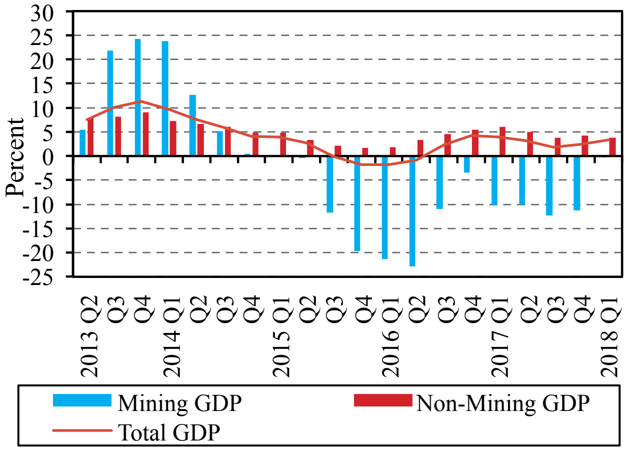
Core Inflation Measures	Description	Advantages	Disadvantages
Inflation by excluding food and fuel (CPIXFF)	Excludes volatile food and fuel items from the CPI basket Widely used across central banks	Easy to compute and communicate	May exclude items that contain important signals about underlying inflation
Inflation by excluding administered prices (CPIXA)	Excludes administered prices from the CPI basket: e.g., water, electricity, postal tariffs, fuel prices	Easy to compute and communicate	May exclude items that contain important signals about underlying inflation
Trimmed mean (CPITM)	Items are arranged according to the magnitude of the price changes for the month For the current trimmed mean measure of inflation for Botswana, 8 percent of items with the highest and 8 percent with the lowest price increases are removed (16 percent in total)	Easy to compute	No consensus on percentage to exclude

3.2 Recent economic developments in Botswana

Modest GDP growth

GDP increased by 3.3 percent in the twelve months to March 2018, compared to a faster expansion of 4 percent in the year to March 2017 (Table 3.3).[1] The lower increase is attributed to a slower growth of 3.8 percent in non-mining GDP compared to 6 percent in the previous year. This, in the main, reflects the deceleration in growth of output for the trade, hotels and restaurants sector, due to lower sales by De Beers Global Sightholder Sales (DBGSS) in the third quarter of 2017. Furthermore, the 0.3 percent decline in mining output, albeit lower than the contraction of 10.2 percent in the previous year, also moderated overall growth. The decline in mining GDP mainly resulted from the closure of the BCL and Tati Nickel mines in October 2016. In contrast, diamond output grew by 13.5 percent, from an increase of 1 percent in the previous year, reflecting improving trading conditions, particularly for rough diamonds in major markets. Similarly, coal output recovered from a contraction of 4.7 percent to growth of 19.9 percent, reflecting increased demand for coal for the Morupule B power plant. Meanwhile, output in the first quarter of 2018 was 4.8 percent larger than for the corresponding period in 2017, but 1.7 percent lower compared to performance in the last quarter of 2017.

Chart 3.3: GDP Growth Rates



Source: Statistics Botswana

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

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

	2017Q1	2017Q4	2018Q1
Total GDP	4.0	2.4	3.3
Mining	-10.2	-11.2	-0.3
Non-Mining	6.0	4.2	3.8
Agriculture	1.7	2.1	2.2
Manufacturing	1.7	1.9	2.9
Water and Electricity	49.2	-19.5	7.5
Construction	4.4	3.5	3.4
Trade, Hotels and Restaurants	17.0	7.3	2.5
Transport and Communications	5.9	4.7	5.2
Financial and Business Services	3.4	5.0	5.1
General Government	2.4	2.2	2.6
Social and Personal Services	3.2	2.8	3.1
Government Final Consumption	2.0	3.0	3.8
Household Final Consumption	1.6	5.0	6.6
Gross Fixed Capital Formation	1.4	-9.4	-7.0
Exports	11.8	-13.3	-18.5
Imports	-11.8	-23.8	-16.8

Source: Statistics Botswana and Bank of Botswana calculations

Diamond production increased in the second quarter of 2018

Production of rough diamonds by Debswana was 6.3 million carats in the second quarter of 2018, compared to 5.8 million carats in the first quarter and 5.8 percent higher than for the corresponding quarter in 2017, as the company maintained its strategy of mining to match market demand.

Production at the Jwaneng Mine increased by 3.8 percent in the second quarter of 2018, compared to a contraction of 2.8 percent for the corresponding quarter in 2017, in response to favourable trading conditions. Similarly, production at the Orapa[2] Mine rose by 7.7 percent in the same period, mainly driven by healthy trading conditions and the commencement of operations at the Damtshaa Mine in January 2018, which had been under care and maintenance since the beginning of 2016. Meanwhile, the Tailings Resource Treatment Plant at the Letlhakane Mine, which is now operational,

[1] Growth rates are reported on a rolling 12-month basis. For example, for 2018Q1, the annual growth is calculated from the level of GDP estimated for the 12 months to March 2018 compared to the level of output for the corresponding 12-month period ending in March 2017.

[2] Orapa output constitutes production from Orapa, Letlhakane and Damtshaa mines.

will have capacity to produce up to 800 000 carats per year and it is envisaged that will extend the life of the Mine by at least twenty years.

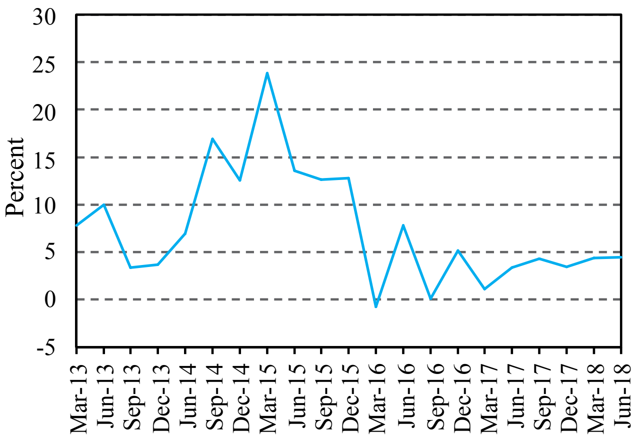
For Lucara Diamond Corporation (Karowe Mine), production increased by 41.4 percent to 81 507 carats in the second quarter of 2018, from 57 624 carats in the corresponding quarter in 2017. During the second quarter of 2018, a total of 253 specials (single diamonds larger than 10.8 carats) were recovered, including eleven diamonds greater than 100 carats. Special stones discovered accounted for 10.5 percent of total carats recovered during the same period.

3.3 Monetary developments

Higher growth in banking sector assets in the second quarter of 2018

Annual growth in banking sector assets increased from 3.4 percent in the second quarter of 2017 to 4.5 percent in the second quarter of 2018 (Chart 3.4). This was due to the overall increase in the growth of loans and advances, which account for the largest proportion of commercial banks' assets.

Chart 3.4: Year-on-Year Commercial Banks' Growth in Total Assets

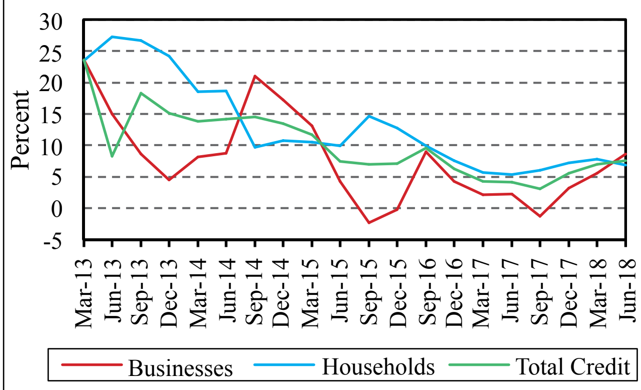


Source: Commercial Banks

Credit growth accelerates in the second quarter of 2018

Yearly growth in commercial bank credit was 7.6 percent in the second quarter of 2018, compared to 4.1 percent in the second quarter of 2017 (Chart 3.5). This was due to the increased growth in lending to the household and business sectors (mainly reflecting the utilisation of existing credit facilities by diamond cutting and polishing companies).

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

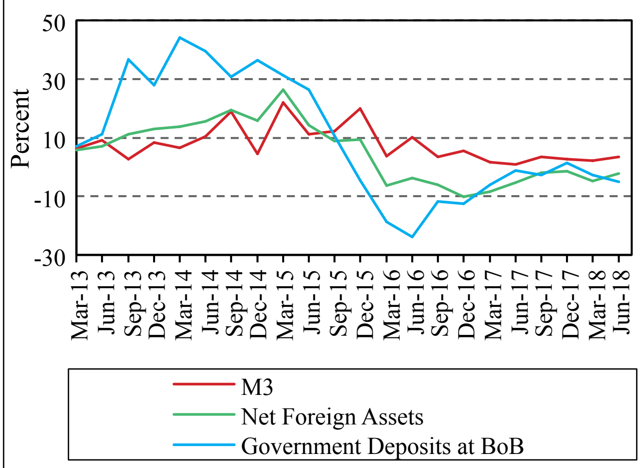


Source: Commercial Banks

Money supply accelerates in the second quarter of 2018

Annual growth in money supply (M3) accelerated from 0.8 percent in the second quarter of 2017 to 3.4 percent in the second quarter of 2018 (Chart 3.6). This was due to the expansionary effect of the decline in government deposits at Bank of Botswana, which was partly offset by a decline in net foreign assets.

Chart 3.6: Year-on-Year Growth on Money Supply



Source: Commercial Banks, Bank of Botswana

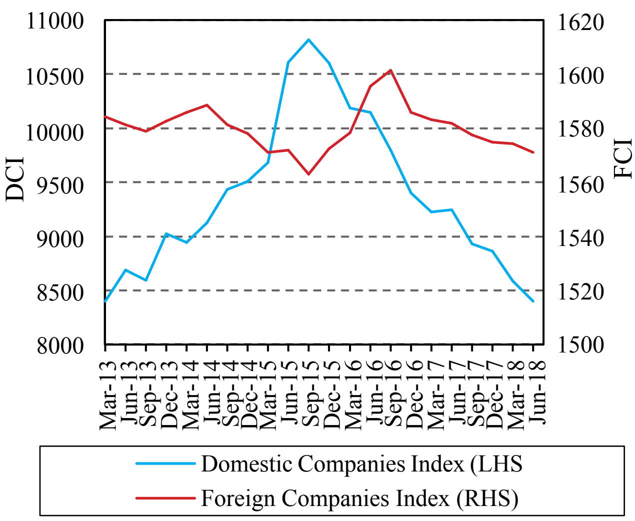
Stock market index declines

The Domestic Companies Index (DCI) declined by a further 9.1 percent in the second quarter of 2018, continuing the downward trend that started in the third quarter of 2015. The recent decrease was mainly due to the decline in prices per share of among others, Botswana Telecommunications Corporation Limited (-35.3 percent), Minergy

(-19.1 percent) and African Energy Resources Limited (-18.5 percent).[3]

The Foreign Companies Index (FCI) also fell by 0.7 percent in the second quarter largely due to the year on year decrease in price per share of Lucara (-16.8 percent) and Botswana Diamonds plc (-9.1 percent).

Chart 3.7: Stock Market Indices



Source: Botswana Stock Exchange

Interest rates for Bank of Botswana Certificates increase

The 14-day BoBC stop-out yield increased to an average of 1.50 percent in the second quarter of 2018 from 1.36 percent in the corresponding period in 2017, while the 3-month BoBC yield also increased to an average of 1.54 percent from 1.43 percent in the same period. In July 2018, the yields were 1.52 percent and 1.55 percent for the 14-day and 3-month BoBCs, respectively. Meanwhile, the real rate of interest for the 14-day BoBC increased to -1.71 percent in the second quarter of 2018 from -2.04 percent in the corresponding quarter in 2017, reflecting the higher increase in the nominal interest rate compared to the decline in inflation in the period. Similarly, the real interest rate for the 3-month BoBC increased from -1.97 percent to -1.67 percent in the same period.

3.4 Property market

Property market remains weak in the first quarter of 2018[4]

The residential property market for the lower-end and medium cost has good demand and supply compared to the weaker higher-end residential housing. Residential property sales in areas adjacent to Gaborone, such as Mogoditshane, Gabane, Oodi and Modipane are concluded at prices 10-20 percent lower than the valuations, signalling weaker demand for housing in those areas. Overall, the average price for residential property sold in the first quarter of 2018 decreased by 2.5 percent to P765 000 compared to the previous quarter.

The market for office space remains weak due to increasing supply from completed construction developments at the Central Business District (CBD) and slow take-up of office space. The supply for office space is likely to increase further going forward, given the ongoing construction projects at the CBD. Meanwhile, the demand for retail space remains fair across all market segments, with two proposed major shopping centres in the CBD and Mogoditshane. In addition, other centres with good demand for retail space are Maun, Francistown and Mahalapye. With regard to industrial property, the supply of vacant bigger warehouse space has decreased, while the demand has improved. Looking ahead, the demand for prime location industrial space is expected to improve.

3.5 Balance of payments

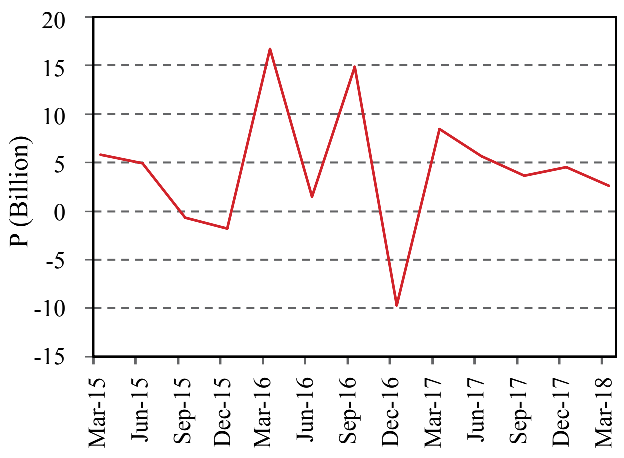
Current account in surplus in the first quarter of 2018

In the first quarter of 2018, the current account recorded a surplus of P2.6 billion, much lower than the P8.5 billion in the first quarter of the previous year (Chart 3.8). The smaller surplus was mainly due to a 23.6 percent fall in diamond exports in the same period, associated with reduced rough diamond prices. Diamonds accounted for 90 percent of total exports in the first quarter of 2018.

3 BTCL share price decline can be attributed to retail investors selling off. For Minergy, the share is an illiquid stock with an unpredictable price movement. AFR share price declined owing to transactions of shareholders who accepted the company's share buyback just prior to its delisting.

4 Data sourced from the Ribbery Report for the first quarter of 2018.

Chart 3.8: Quartely Current Account Balance



Source: Bank of Botswana

The surplus in the current account was supported by the Southern African Customs Union (SACU) receipts, which increased by 53.3 percent from P3.0 billion in the first quarter of 2017 to P4.6 billion in the first quarter of 2018.

Decreased outflow from the financial account in the first quarter of 2018

The overall financial account had an estimated net outflow of P1.3 billion during the first quarter of 2018 compared to a net outflow of P11.4 billion in the first quarter of 2017. The lower net outflow is attributable to, among others, a decrease in offshore deposits with parent companies[5], which declined from P7 billion to approximately P500 million.

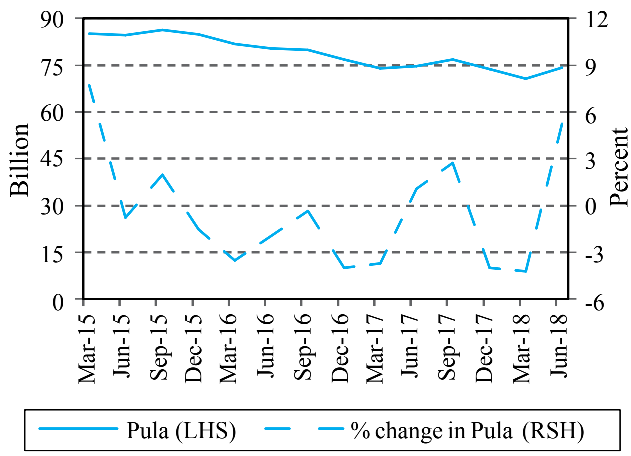
The overall balance of payments recorded a deficit of P2.9 billion in the twelve months to June 2018 compared to a deficit of P2.1 billion in the corresponding period in 2017.

Foreign exchange reserves decrease

At the end of June 2018, the foreign exchange reserves amounted to P74.3 billion, a decrease of 0.5 percent from P74.7 billion in June 2017 (Chart 3.9). The decrease in the foreign exchange reserves mainly reflected foreign exchange outflows.

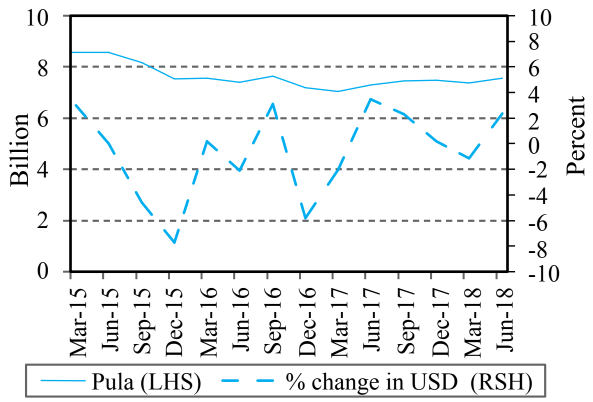
In USD terms, the reserves decreased by 2.7 percent from USD7.3 billion in June 2017 to USD7.1 billion in June 2018. The reserves decreased by 1.9 percent in SDR terms from SDR5.2 billion to SDR5.1 billion in the same period. The import cover for goods and services as at the end of June 2018 was 18.3 months.

Chart 3.9: Foreign Exchange Reserves in Pula and Quarterly Percentage Change



Source: Bank of Botswana

Chart 3.10: Foreign Exchange Reserves in US Dollar and Quarterly PercentageChange



Source: Bank of Botswana

3.6 Exchange rate developments

For 2018, the Bank's implementation of the exchange rate policy (Box 2) entails the basket weights of the Pula at 45 percent for the South African rand and 55 percent for the SDR and a 0.3 percent downward rate of crawl. A gradual downward adjustment of the annual rate of crawl seeks to minimise the risk of a further appreciation of the real effective exchange rate (REER).

Bilaterally, the Pula appreciated by 0.4 percent against the South African rand, but depreciated by 0.5 percent against the SDR over the twelve months to July 2018 (Chart 3.11). Over the same period, it depreciated by 0.8 percent against the British pound, 0.7 percent against the US dollar, 0.6

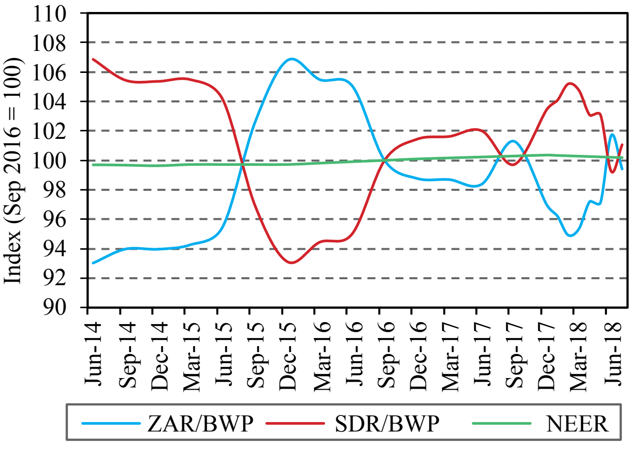
5 These are deposits held by enterprises operating in Botswana with foreign shareholding and having made deposits with these foreign entities.

percent against the euro and 0.1 percent against the Japanese yen, while it appreciated by 0.9 percent against the Chinese renminbi.

The movement of the Pula against the constituent SDR currencies largely reflects the performance of the South African rand against the SDR currencies. In the same review period, the rand depreciated against the SDR (by 0.9 percent) and all its constituent currencies, except the Chinese renminbi. It depreciated by 1.2 percent against both the British pound and the US dollar, 1 percent against the euro and 0.5 percent against the Japanese yen, while it appreciated by 0.4 percent against the Chinese renminbi.

The rand depreciated against major currencies due to the global investor risk aversion amidst the emerging trade war between the United States and other countries (such as China, EU countries and Russia). This, in turn, resulted in major financial outflows from emerging markets towards developed economies. South Africa is one of the most vulnerable emerging market economies to market re-adjustments.[6] Furthermore, the rand weakened as investors continued to reposition long-term investment from risky assets in favour of investments in safe haven currencies such as the US dollar and Swiss franc.

Chart 3.11: Nominal Exchange Rate Indices

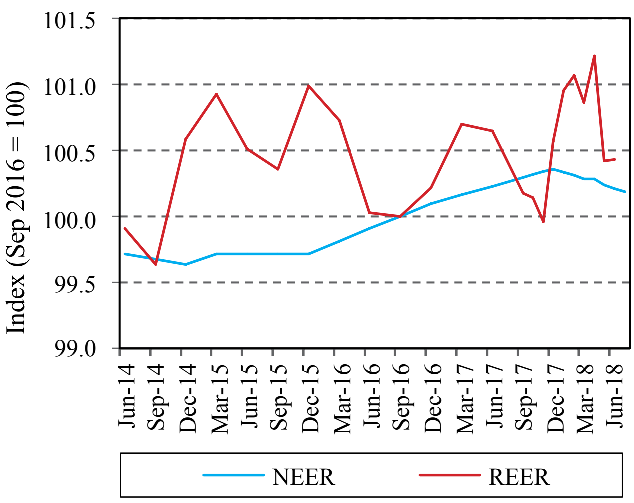


Source: Bank of Botswana

Nominal effective exchange rate (NEER) depreciates

The nominal effective exchange rate of the Pula depreciated by 0.06 percent in the twelve months to July 2018 (Chart 3.12); consistent with the transition from an annual upward rate of crawl of 0.26 percent

Chart 3.12: Nominal and Real Effective Exchange Rates



Source: Bank of Botswana

implemented in 2017 to a downward annual rate of crawl of 0.3 percent, effective January 2018.

REER depreciates

The real effective exchange rate (REER) depreciated by 0.21 percent in the twelve months to June 2018 (Chart 3.12), largely reflecting a negative inflation differential between Botswana and trading partner countries, amidst the relatively stable NEER. Average inflation for the trading partner countries was 3.3 percent in the review period compared to 3.1 percent for Botswana. With respect to bilateral movements against the Pula basket currencies, the real exchange rate of the Pula appreciated by 1.9 percent against the South African rand, but depreciated by 1.9 percent against the SDR over the same period. Against the SDR constituent currencies, the local currency depreciated in real terms by 2.4 percent against the euro, 2.8 percent against the Chinese renminbi, 1.8 percent against the British pound, 1.6 percent against the US dollar and 0.7 percent against the Japanese yen.

[6] South African bonds are mainly held by foreign investors.

Box 2: Botswana's Exchange Rate Framework

The Exchange Rate Policy

Botswana's exchange rate policy is aimed at maintaining the level of competitiveness of local producers of tradeable goods and services in both 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 on the basis of 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 Current Exchange Rate Framework

The crawling peg 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 that may be implemented unexpectedly. In the crawling peg framework, prospects for changes in competitiveness (i.e., inflation differentials between Botswana and trading partner countries) are projected and the exchange rate is set to adjust gradually to forestall the potential loss in price competitiveness.

An important goal of the exchange rate policy is the stabilisation of the real effective exchange rate in relation to Botswana's main trading partners. In line with this objective, the authorities closely monitor the relative inflation performance between Botswana and her trading partners.

3.7 Recent global economic developments

Global growth momentum continues

According to the July 2018 World Economic Outlook (WEO) Update, global output is expected to expand by 3.9 percent in 2018, higher than the 3.7 percent growth in 2017. The forecast for global output is underpinned by developments in advanced economies, such as accommodative financial conditions and the positive spill-over effects of expansionary fiscal policy in the United States (US). However, downside risks to global economic performance include inward-looking policies, rising trade tensions, tighter financial conditions and geopolitical tensions.

Growth in US economic activity accelerates

For the US, economic growth in the second quarter of 2018 increased to 4.1 percent, the fastest pace in almost four years, from the revised 2 percent in the first quarter. The USD1.4 trillion income tax cut package, which came into effect in January 2018, helped spur economic growth as consumers and government increased spending in the quarter. Annual GDP growth in 2018 is expected to be close to the US administration's 3 percent target. The tax cuts and the fiscal stimulus are, however, expected to widen the current account deficit.

Euro zone growth weakens

GDP in the euro zone expanded by 0.4 percent in the first quarter of 2018 compared to 0.7 percent growth in the fourth quarter of 2017. Of the 19 European Union (EU) countries that have reported first quarter GDP, only Poland, Finland, Bulgaria and Latvia experienced a faster rate of economic growth. Investor confidence took a dip, partly due to concerns about a trade war with the US after President Trump imposed duties of 25 percent on steel and 10 percent on aluminium imports from the EU in March 2018.[7] The decision to impose the tariffs has led to fears of a wider trade war in which

[7] Although the EU retaliated against the US administration's tariffs in June 2018 by imposing penalties on American products, the US and EU are expected to resolve the retaliatory tariff issues following a meeting between President Donald Trump and the European Commission President, Jean-Claude Juncker. They are expected to hold off further tariffs and reassess existing tariffs on steel and aluminium.

countries try to punish each other by increasing taxes on traded goods, which could hold back the growth of the global economy.

Growth modest in the UK

In the United Kingdom (UK), GDP grew at a modest pace of 0.4 percent in the second quarter of 2018, following a 0.2 percent expansion in the previous quarter. The higher growth reflected increased household consumption and investment. High inflation continues to dampen real growth in household income and business investment, amidst continued uncertainty about the future relationship between the UK and the EU. There have been increasingly strident warnings that businesses could relocate jobs and investment to the EU after Brexit.

Emerging markets' growth strengthens

Economic growth improved in emerging market economies, primarily from acceleration in private consumption. The strengthening of economic growth is predicated on higher commodity prices and improved demand. In addition, continued fiscal support is a fundamental driving force of output expansion in key emerging market economies, notably Brazil and Russia[8]. In addition, China's economy grew by 6.8 percent in the first quarter of 2018, slightly higher than expected, buoyed by strong consumer demand and robust property investment.

In India, GDP grew by 7.7 percent in the quarter ended March 2018. The rapid growth in agriculture, manufacturing and construction sectors contributed to the overall growth of the economy. Meanwhile, there are concerns that rising inflation, fuelled by higher oil prices and a weaker rupee, could start to dent growth in India.

Weak economic growth in South Africa

After growing by 3.1 percent in the fourth quarter of 2017, South Africa's level of output fell by 2.2 percent in the first quarter of 2018, highlighting the economic hurdles facing President Ramaphosa, who assumed the country's presidency in February 2018. The agriculture, mining and manufacturing industries were the largest negative contributors to growth in GDP in the first quarter. Agriculture's relatively strong performance in 2017 is one of the positive factors that helped keep the economy afloat. This momentum failed to carry through to 2018, with decreased production in field crops and horticultural products contributing to the decline in GDP in the first quarter.

Although investor sentiment improved, following the signing of the Renewable Energy Independent Power Producer Project (REIPPP) Agreement in April 2018, which is expected to result in R55.92 billion worth of new investments in the energy sector and create nearly 60,000 jobs; both consumers and firms are facing headwinds (inflation rose in June 2018 due to the residual effects of the increase in the VAT rate and high fuel prices, while the emerging market sell-off resulted in an increase in the cost of imports).

Table 3.4: Growth Estimates and Projections

	Estimate		Projection	Projection
	2016	2017	2018	2019
Global	3.2	3.8	3.9	3.9
Advanced economies	1.7	2.3	2.4	2.2
USA	1.5	2.3	2.9	2.7
Euro area	1.8	2.3	2.2	1.9
United Kingdom	1.9	1.8	1.4	1.5
Japan	0.9	1.7	1.0	0.9
Emerging market and developing economies	4.4	4.8	4.9	5.1
China	6.7	6.9	6.6	6.4
Brazil	-3.5	1.0	1.8	2.5
India	7.1	6.7	7.3	7.5
Russia	-0.2	1.5	1.7	1.5
South Africa	0.6	1.3	1.5	1.7
Botswana	4.3	2.2	4.6	4.5

Source: IMF WEO 2018

Global commodity prices

Diamond prices increase

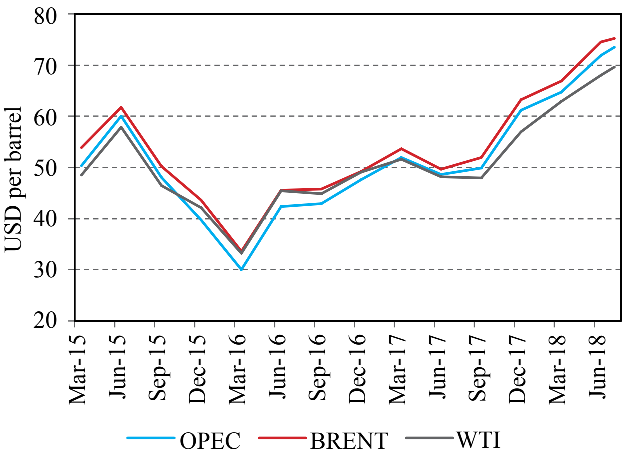
The Zimnisky Global Rough Diamond Price Index indicates that global rough diamond prices rose by 3 percent in the second quarter of 2018, compared to an increase of 2 percent in the first quarter, against the backdrop of a strong global economy, improved US consumer sentiment and signs of a stronger Chinese market. Correspondingly, polished diamond prices increased.

[8] The US has announced that it will impose restrictions on the export of sensitive technology to Russia, effective August 2018, which could result in investors selling off Russian debt.

Oil prices increased in the second quarter of 2018

International oil prices increased to above USD70 per barrel in the second quarter of 2018, a marked increase from around USD45 per barrel in the second quarter of 2017. The OPEC reference crude oil basket price averaged USD71.92 per barrel in the second quarter of 2018, while the price of Brent crude averaged USD74.50 per barrel in the second quarter of 2018. The OPEC price was largely unchanged between June and July 2018 at around USD73.30 per barrel. OPEC (and its non-OPEC partners) have agreed to increase oil production from July 2018 in a move that signals a willingness by international suppliers to address rising oil prices, after crude oil prices soared, boosted by strong demand and renewed US sanctions against Iran. Overall, developments in the international oil market imply marginal upward pressure on Botswana inflation.

Chart 3.13: Oil Prices

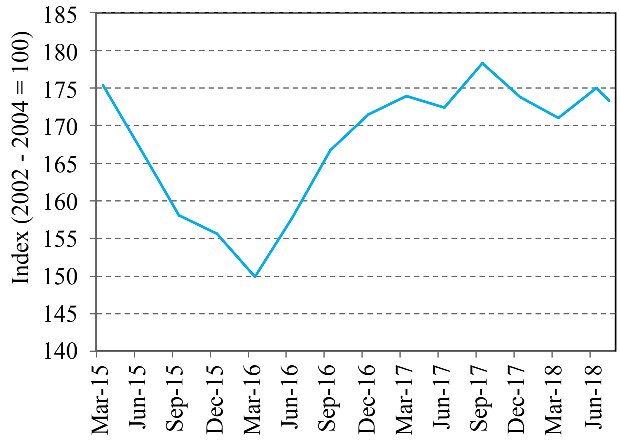


Source: OPEC and US Energy Information

Food prices increased in the second quarter of 2018

According to the United Nations Food and Agriculture Organisation (FAO), global food prices increased by 1.5 percent in the second quarter of 2018 compared to a higher increase of 9.3 percent in the second quarter of 2017 (Chart 3.14). The prices for the food categories (cereal, vegetable oils, sugar and meat) increased while prices of dairy products declined in the period. Food prices declined by 1.4 percent in the year to July 2018. In Southern Africa, food prices are expected to increase due to reduced crop production, following the drought conditions experienced in December 2017 and January 2018. Overall, there is potential modest upward pressure from food prices on domestic inflation.

Chart 3.14: Food Price Index

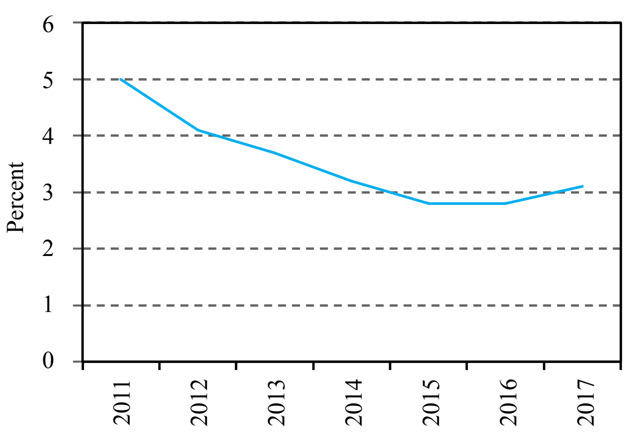


Source: Food and Agriculture Oragnisations

Global inflation increases

The upward trend in commodity prices, such as oil, contributed to the increase in global inflation in the second quarter of 2018. The increase was broad-based, as inflation firmed in both developed and emerging market economies, with the euro zone, India and the United States recording noticeable rises. International oil prices remained above USD70 per barrel, influenced by concerns about crude oil supply disruptions and increased demand. South Africa's headline inflation averaged 4.5 percent in the second quarter of 2018 and was lower than the average of 5.3 percent in the corresponding quarter in 2017. South Africa's headline inflation rose from 4.6 percent in June 2018 to 5.1 percent in July, largely due to increase in administered prices. Inflation has remained within the South African Reserve Bank's target range of 3 – 6 percent since April 2017.

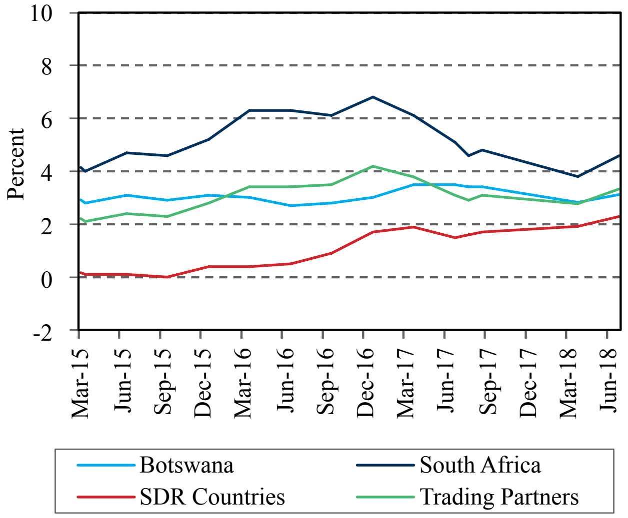
Chart 3.15: Global Inflation



Source: Bloomberg

Meanwhile, the average trade-weighted inflation for Botswana's trading partners increased slightly from 3.1 percent in June 2017 to 3.3 percent in June 2018 (Chart 3.16).

Chart 3.16: Botswana Inflation and International Inflation



Source: Statistics Botswana and Bloomberg

Mixed monetary policy developments

In the recent policy decisions in advanced economies, the European Central Bank (ECB) and Bank of Japan (BoJ) maintained their ultra-accommodative monetary policy stances, particularly asset purchases and low policy rates. The US Federal Funds Rate range was maintained at 1.75 percent to 2 percent in August 2018, as risks to the economic outlook were considered to be somewhat balanced. Conversely, the Bank of England (BoE) increased the Bank Rate by 25 basis points to 0.75 percent at its August 2018 meeting, citing the positive domestic growth outlook.

Meanwhile, in emerging market economies, central banks maintained key policy rates, except the Reserve Bank of India, which increased its policy rate by 25 basis points to 6.5 percent in August 2018, on account of inflation concerns arising from higher international oil prices. The Central Bank of Russia and Bank of Brazil maintained their policy rates at 7.25 percent and 6.5 percent in July and August 2018, respectively, in the context of a positive inflation outlook. Similarly, the South African Reserve Bank maintained the policy rate at 6.5 percent at the July 2018 MPC meeting, given balanced risks to the growth forecast.

Table 3.5: Monetary Policy Decisions

Central Bank	Latest Meeting	Current Policy Rate (Percent)	Change from Previous Meeting
Bank of Botswana	August 2018	5.00	No change
South African Reserve Bank	July 2018	6.50	No change
US Federal Reserve	August 2018	1.75 – 2.00	No change
Bank of England	August 2018	0.75	Increase by 0.25 percentage points
European Central Bank	July 2018	0.00	No change
Bank of Japan	July 2018	-0.10	No change
People's Bank of China	June 2018	4.35	No change

4. THE ECONOMIC AND POLICY OUTLOOK

4.1 Global economic prospects

The global economic outlook remains positive, mainly supported by accommodative monetary policies and fiscal policy support in advanced economies. For emerging market and developing economies (EMDEs), the forecast expansion in output reflects the impact of anticipated rebound in prices of some export commodities and improved growth in some key export markets. In addition, continued fiscal support is expected to boost output growth in large economies such as China. In South Africa, the growth outlook is expected to remain subdued on account of structural bottlenecks due to the slow economic reform agenda, including the proposed constitutional review to provide for expropriation of land without compensation, which is likely to weigh down on consumer and business confidence. With regard to the inflation outlook, projections indicate that global inflation will increase modestly in the near term, due to the anticipated increase in international oil and food prices.

Global economic outlook remains positive
Global output is expected to expand by 3.9 percent in 2018 and 2019, according to the July 2018 WEO Update. Advanced economies' growth is expected to remain above trend at 2.4 percent in 2018 as financial market conditions remain accommodative, before easing to 2.2 percent in 2019.

Although the near-term momentum is expected to strengthen in the US, following the approval of federal government tax cuts, the downside risks have increased as the announced and anticipated import tariff increases by the US are expected to derail the recovery and depress the medium-term growth prospects by raising uncertainty. Other downside risks include the geopolitical tensions, potential build-up of financial vulnerabilities induced by easy financial conditions and political uncertainty.

UK economic growth to weaken
The UK economy is expected to grow by 1.4 percent and 1.5 percent in 2018 and 2019, respectively, compared to 1.7 percent in 2017. The weakness is anticipated to be more pronounced in consumption expenditure, reflecting the erosion of purchasing power arising from the increase in inflation. In addition, the prolonged uncertainty associated with Brexit is expected to continue to dampen investor confidence and exert downward pressure on demand.

Positive economic outlook for US
For the US, growth forecasts for 2018 and 2019 are 2.9 percent and 2.7 percent, respectively. The positive projections are on account of stronger external demand and the expected positive impact of the substantial fiscal stimulus, particularly the reduction in the corporate tax rate. The assumption is that the decrease in tax revenues will not be offset by spending cuts in the near term; therefore, the tax reform is expected to stimulate economic activity in the US.

Growth for the euro area to slow down
In the euro area, economic growth is projected at 2.2 percent in 2018, before slowing down to 1.9 percent in 2019. Accommodative monetary policy in most euro area countries, fiscal policy stimulus and improving labour markets are expected to support domestic demand in 2018, while the slowdown in 2019 is due to the expected lower trade, which coincides with tariffs imposed on steel and aluminium products from the euro area by the US. Growth forecasts for Germany and France were revised downwards for both 2018 and 2019, after the rate of increase in activity softened more than expected in the first quarter. In Italy, tighter financial conditions amid the recent political uncertainty are expected to weigh down on domestic demand. Moreover, the Italian government passed a bill in July 2018 to limit temporary job contracts and penalise companies that move production offshore as this would hamper job creation, discourage foreign investment and weaken consumer spending.

Robust growth in emerging markets
Meanwhile, in emerging market and developing economies, growth in economic activity is expected to remain robust, buoyed by stronger commodity prices and improved demand, easy financing conditions in some commodity-exporting countries and an overall positive outlook for global trade and investment. Output growth in emerging market and developing economies is expected to increase by 4.9 percent and 5.1 percent in 2018 and 2019, respectively, from the estimated growth of 4.7 percent in 2017. In addition, continued fiscal support

is expected to be fundamental for output expansion in key emerging market economies.

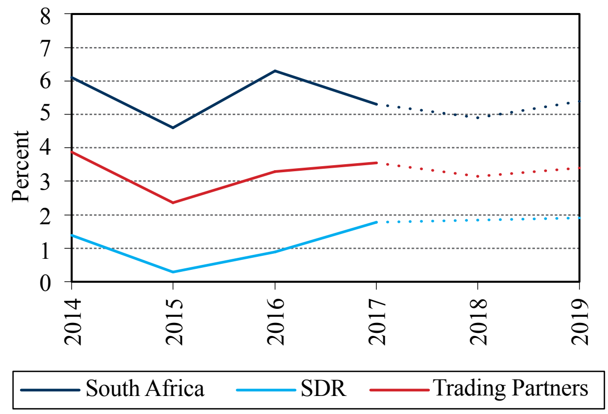
Growth in the South African economy to remain subdued

Growth prospects in South Africa are expected to remain subdued as output projections are weighed down by the widening fiscal account deficit and slow reform agenda. Moreover, the economy is likely to be adversely affected by the parliamentary decision to pursue land expropriation without compensation[9], as well as the ruling African National Congress' (ANC) resolution to nationalise the South African Reserve Bank. The moderating level of investment and consumer spending highlights the economy's hurdles. Rating agencies have cast doubt on the country's ability to meaningfully grow the economy, despite signs of improvement in governance following the appointment of President Cyril Ramaphosa. In addition, concerns remain over the high unemployment rate, while the new US import tariffs might have an adverse impact on South Africa's economic growth[10], possibly resulting in reduced sales and loss of jobs.

Global inflation to increase

Globally, the inflation outlook remains favourable in 2018, although there are indications of emerging upside pressures, partly from higher oil prices. Inflation is forecast to increase from 3 percent in 2017 to 3.5 percent in 2018. In advanced economies, inflation is expected to maintain an upward trend as oil prices increase. For emerging market economies, inflation is expected to increase on account of higher international oil prices and the continued fiscal support that is expected to boost economic activity. Meanwhile, in South Africa, inflation forecasts have been revised downwards from 4.9 percent to 4.8 percent for 2018, as the impact of the value-added tax (VAT) on inflation is less than anticipated. The weaker rand exchange rate and the higher oil price assumptions have resulted in an upward revision of the inflation forecast for 2019, from 5.2 percent to 5.6 percent. However, inflation is anticipated to remain within the SARB's target range in the short-to-medium term (Chart 4.1). Furthermore, in the short to medium term, the role of monetary policy in supporting growth in emerging economies may be constrained by the tightening cycle in the United States. Monetary policy across many countries is, therefore, expected to tighten, in order to curb inflation and maintain inflation expectations in line with inflation targets.

Chart 4.1: South Africa and SDR Headline Inflation



Source: SARB and Bloomberg

Commodity prices to rise

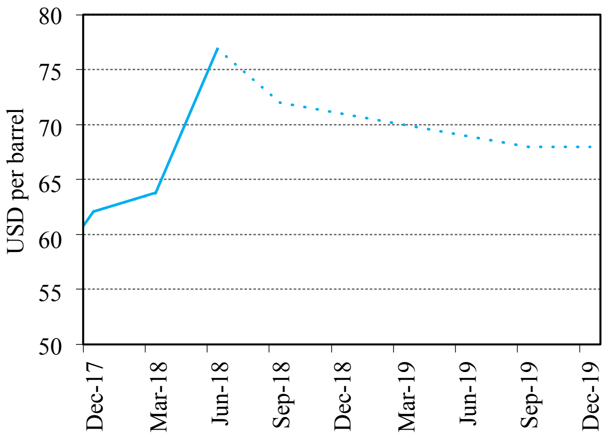
International oil prices are expected to fall, but remain high, as geopolitical tensions have raised risks of supply disruptions (Chart 4.2). The political and economic crises affecting the oil-rich South American country, Venezuela, have resulted in a reduction in its crude oil production, which is expected to tighten oil markets much more quickly than previously anticipated. The high oil prices also reflect a buoyant global economy that has boosted demand. Furthermore, the US President's decision to unilaterally exit the nuclear deal with Iran and impose sanctions may result in an increase in the price of crude oil.[11] Conversely, if tensions between China and the US escalate, growth in global trade volumes is likely to slow and, as a result, oil demand (and prices) could fall.

9 South African leaders are at loggerheads over the issue of land expropriation without compensation. The debate has largely focused on whether the current legislation provides sufficient leeway to expropriate land without compensation and whether it can be done with minimum interruptions to agricultural output.

10 The most direct harm could result from the US administration's import tariffs on steel and aluminium. In 2017, South Africa exported about R4.7 billion worth of aluminium and R11.8 billion worth of steel to the US.

11 The US has re-imposed economic sanctions against Iran which ban any transactions with Iran involving US dollar banknotes, gold, precious metals, aluminium, steel, commercial passenger aircraft and end imports of Iranian carpets and foodstuffs into the US.

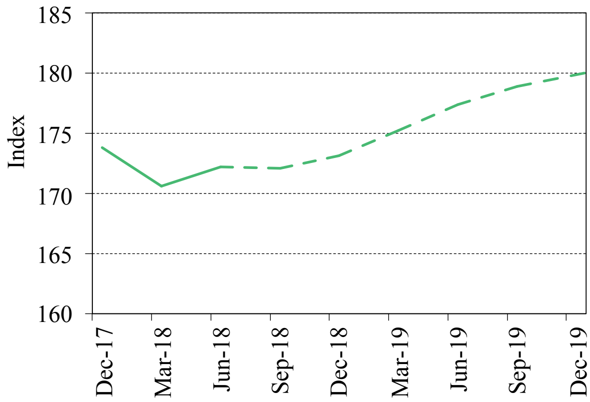
Chart 4.2: International Oil Prices



Source: Bloomberg

Prospects for global food production in 2018 are more restrained and food prices are likely to exert upward pressure on inflation (Chart 4.3). In Southern Africa, most countries have been affected by the drought conditions (below average rainfall and high temperatures), resulting in poor crop harvest across several countries. The expected reduction in crop production will likely trigger price increases.

Chart 4.3: International Food Prices Index



Source: FAO and Bloomberg

4.2 Outlook for domestic economic activity

Against the backdrop of the positive global economic outlook, domestic output growth is expected to increase in the short to medium term as a result of the recovery in the mining sector. Furthermore, the projected accommodative monetary conditions and growth in government expenditure in the 2018/19 fiscal year, as well as the stable water and electricity supply, are expected to sustain output growth in the non-mining sectors. Overall, however, the economy is expected to operate below its potential in the medium term.

Improvement expected in domestic output

In the context of the anticipated improvement in most advanced and emerging market economies, which are major markets for Botswana's rough diamonds, domestic economic activity is expected to increase in the short to medium term.[12]

It is expected that non-mining output will increase in 2018 and 2019, reflecting better performance (see Box 3 for more details) due to improved global demand. The anticipated stability in water and electricity supply, the projected expansion in government expenditure in the 2018/19 fiscal year and other activities promoted by government economic diversification initiatives, such as the promotion of dam tourism and implementation of reforms on ease of doing business, will be supportive of growth in the non-mining sectors. Moreover, the accommodative monetary policy should help move the economy towards full capacity in the medium term.

Meanwhile, the protectionist policies by the US and China could have a negative impact on global trade and, in turn, global economic growth. This could result in a fall in global demand and commodity prices, especially those of rough diamonds, and impact negatively on the domestic economic outlook.

[12] It is expected that diamond production will remain firm in 2018, given that Debswana has set itself a higher target of 23.8 million carats for 2018 compared to 22.7 million carats produced in 2017.

Box 3: Expected Drivers of Non-Mining Sectors

Trade, Hotels and Restaurants

- Envisaged increase in DBGSS and ODC output due to improved global demand for rough diamonds.
- Continued implementation of events-based-tourism initiatives, such as the Khawa Sand Dune challenge and cultural festivals, promotion of dam tourism and government efforts to develop heritage sites. These developments would create employment and enhance economic activity in the recreation and hotels sub-sectors.
- Government initiatives aimed at facilitating the ease of doing business in Botswana, e.g., the Immigration Law has been amended to allow non-citizen investors with significant contribution to the economy to apply for permanent residence within five years.

Finance and Business Services

- Increase in financial and business services as a result of implementation of reforms on ease of doing business in Botswana and also improved business confidence level in the recent Business Expectations Survey (BES). FinTech developments, such as electronic and cellphone banking services by some banks, will boost the sector and promote greater financial inclusion.

Construction

- Implementation of infrastructure projects through development spending, such as the North-South Water Carrier 2 and implementation of the North-West Electricity Transmission Grid.
- Continued land servicing initiatives would boost the construction sector and ultimately industries will start operating in areas outside main cities and towns which will stimulate economic growth.
- Construction of transport-related infrastructure, such as the Boatle-Gaborone dual carriage road, Mohembo Bridge and Kazungula Bridge.

Transport and Communications

- Government's efforts to develop ICT through broadening network coverage.

Manufacturing

- Downstream diamond polishing activities expected to benefit from the improved global economy.
- Economic Diversification Drive initiative that the Government should procure from local manufacturers.
- Increase in meat and meat products due to improved livestock production.
- Reform of BMC and liberalisation of the beef export market.
- Expansion of dairy sub-sector by improving strategic dairy farms and leasing out unutilised farms to the private sector.

Water and Electricity

- Operation of the Morupule A power plant, which has been under refurbishment.

Agriculture

- Livestock production expected to improve on account of continued efforts to contain the foot and mouth disease outbreaks.
- Continued government subsidies through the Livestock Management and Infrastructure Development (LIMID) project and the Integrated Support Programme for Arable Agriculture Development (ISPAAD).

Social and Personal Services

- Continued government efforts to promote growth of Small, Medium and Micro Enterprises (SMMEs) and citizen economic empowerment initiatives are expected to boost household business enterprises. For example, Government has signed a Memorandum of Understanding (MoU) with the De Beers Group of companies to facilitate implementation of the Tokafala Enterprise Development Programme. The Programme is aimed at accelerating the growth of SMMEs through mentorship, advisory services and promoting business linkages, which are expected to improve productive capacity of local enterprises to supply both the domestic and export markets.

4.3 Domestic inflation outlook

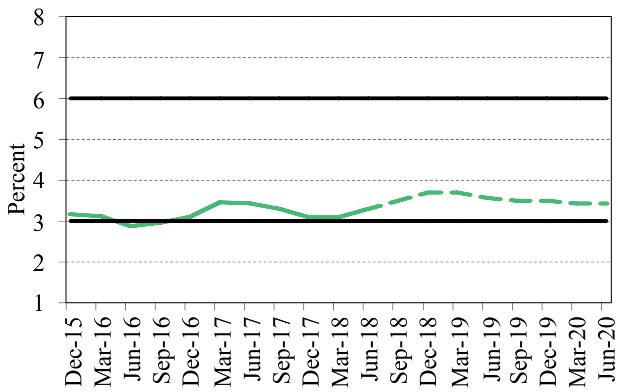
The Bank's August 2018 forecast of headline inflation shows an increase in inflation in the short term, which, however, is expected to remain within the 3 - 6 percent medium-term objective range in the medium term. The inflation forecast mainly reflects the upward revision of the forecast for international commodity prices and trading partner inflation. The main downside risk to the inflation outlook relates to any significant reduction in government levies and weak demand, which might arise from the restrained increase in personal incomes and subdued growth in economic activity. Upside risks to the inflation outlook relate to any substantial upward adjustment in administered prices, government levies and international oil and food prices beyond current forecasts.

Inflation remains within the objective range
Headline inflation is projected to remain within the Bank's medium-term objective range in the short to medium term (Chart 4.4). However, inflation is forecast to increase in the short term, reaching a peak of 3.9 percent in the fourth quarter of 2018, before trending downward in the medium term.

It is expected that domestic demand pressures on inflation will remain weak in the short to medium term, mainly on account of restrained growth in personal incomes and subdued growth in economic activity. However, there are prospects for improvement in the domestic economy, which emanate from anticipated expansions in the global economic activity (Table 3.4) and projected accommodative monetary conditions as measured by the Real Monetary Conditions Index (RMCI)[13]. Nonetheless, it is expected that the economy will be operating below potential in the forecast period.

With regard to the prospective exchange rate developments, the Pula is forecast to appreciate against the rand, although at a lower rate than in 2017. The appreciation is mainly driven by the depreciation of the rand against major trading partner currencies as the proposed policy of expropriation of land without compensation, reduced liquidity and tighter monetary policy in developed economies are likely to continue to weigh down on the rand. Meanwhile, according to the Business Expectations Survey of March 2018, businesses expect inflation to remain within the objective range in the medium term.

Chart 4.4: Botswana Headline Inflation Forecast



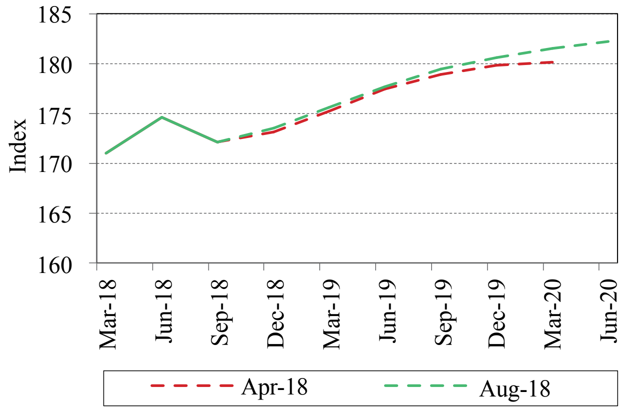
Source: Bank of Botswana

Core inflation low and stable
Core inflation (inflation excluding food and oil inflation) is forecast to increase slightly in the short term, reflecting, in part, the potential boost of the projected accommodative real monetary conditions on non-mining economic activity. This measure of core inflation is, however, projected to be stable in the medium term.

International food prices to increase
International food prices continued to fall in the second quarter of 2018. However, food prices are forecast to rebound in the third quarter of 2018 and rise steadily into 2019 (Chart 4.5). Compared to the April 2018 forecast, international food prices have been revised slightly upwards in the entire forecast horizon, mainly due to the drought conditions (below average rainfall and high temperatures) in Southern Africa, which may result in poor crop conditions across several countries in the region.

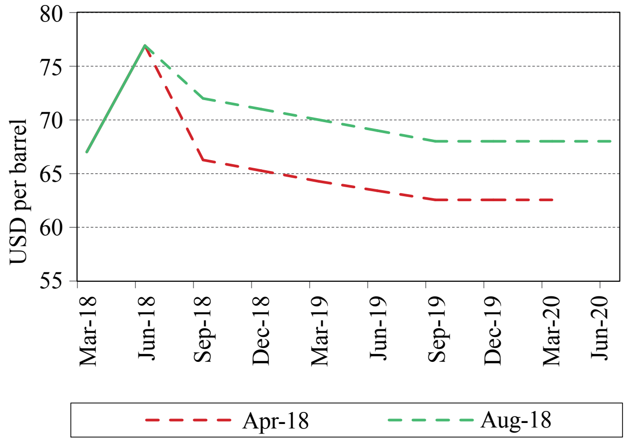
[13] The RMCI measures the relative easiness or tightness of monetary conditions and gauges the likely effect that monetary policy has on the economy through changes in the exchange rate and interest rates. The RMCI combines, through a weighted average, the deviations of the real exchange rate and real interest rate from their respective trend values.

Chart 4.5: International Food Prices (FAO Index)



Source: Bloomberg

Chart 4.6: International Oil Prices



Source: Bloomberg

International oil prices to decrease
International oil prices are projected to fall gradually from USD76.90 per barrel in the second quarter of 2018 to an average of USD68 per barrel in the medium term (Chart 4.6). Compared to the April 2018 forecasts, international oil prices have been revised upwards, as geopolitical tensions have raised risks of supply disruptions. The political and economic crises affecting the oil-rich South American country, Venezuela, have resulted in a reduction in its crude oil production, which is expected to tighten oil markets much more quickly than previously anticipated.

Furthermore, the US President's decision to unilaterally exit the nuclear deal with Iran and re-impose sanctions may cause markets to price-in the impact of the potential decline of Iranian crude exports, which may further push oil prices upward.

Overall, developments with respect to international oil and regional food prices imply some modest upward pressure on domestic inflation.

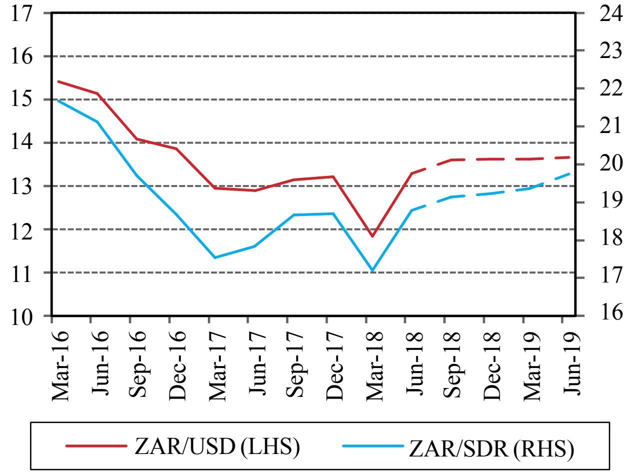
Inflation forecast revised upwards
Since April 2018, dynamics relating to administered prices, trading partner inflation and assumptions regarding international commodity price projections have modestly changed. As a result, the domestic inflation forecast is revised slightly upwards in the short term. The relatively high inflation projection profile mainly reflects the upward revision of trading partner inflation and international food and oil price forecasts.

Exchange rate movements
The Pula exchange rate is determined by the cross-movements of the Pula basket currencies and the rate of crawl. Once the basket composition and the rate of crawl (based on inflation differentials) are determined, the daily changes in the value of the Pula against other currencies would be due to factors that are outside the control of Botswana authorities. It is, rather, the movements in the cross rates of the rand, US dollar, euro, pound sterling, Chinese renminbi and Japanese yen against each other, and their relative weights in the composite currency basket, that determine the value of the Pula.

The South African rand is projected to weaken in the next four quarters (Chart 4.7), due to, in the main, concerns about the proposed policy on land expropriation without compensation, and the rulling party, the ANC's resolution to nationalise the South African Reserve Bank. Both policies could raise uncertainty and dent investor confidence if implemented.

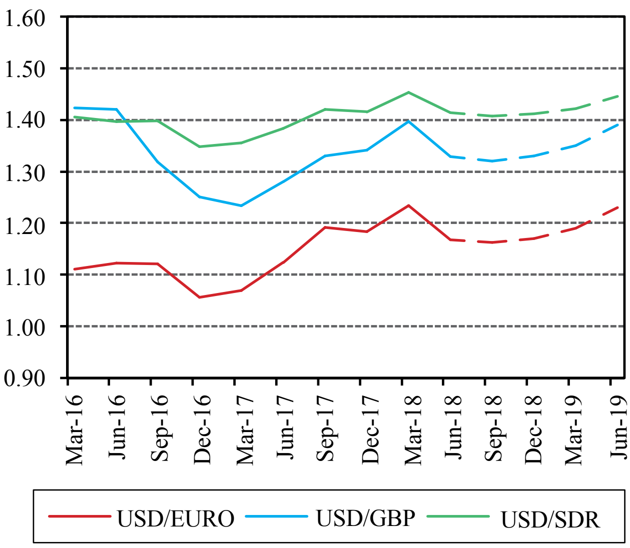
In addition, tighter monetary policies in developed markets are creating volatility across emerging markets, including in South Africa, which is one of the emerging market economies most vulnerable to major markets adjustments. Following the global financial crisis, both the US Federal Reserve (Fed) and European Central Bank (ECB) engaged in quantitative easing to promote economic growth in their respective countries. The current cutting back on quantitative easing and monetary policy tightening means there will be less liquidity globally, and thus less investment flows to emerging markets. The rand is, therefore, expected to depreciate against major international currencies in the next four quarters (Chart 4.7). Consequently, the Pula is expected to appreciate against the rand over the same period.

Chart 4.7: ZAR against USD and SDR



Source: Reuters

Chart 4.8: Exchange Rates against USD



Source: Reuters

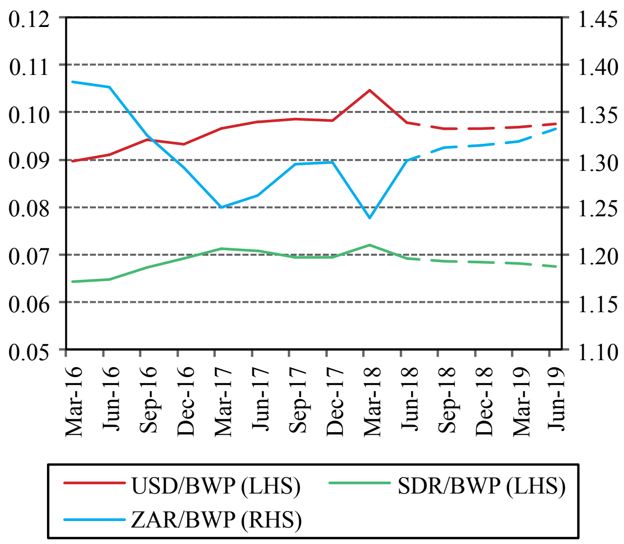
The US dollar is expected to depreciate against other major international currencies in the next four quarters (Chart 4.8). This is due to the expected huge US budget deficit arising from aggressive tax cuts passed by Congress this year. The US fiscal deficit is projected to surpass USD1 trillion in 2020, amidst unrestrained government spending and large corporate tax cuts; these fiscal stimuli are expected to buoy the economy only moderately. The US dollar is also likely to weaken as other major central banks move towards policy tightening, albeit at different speeds, thus closing the interest rate gap with the United States.

The British pound is expected to appreciate against major currencies owing to monetary policy normalisation; the Bank of England has increased the interest rate by a quarter of a percentage point from 0.5 percent to 0.75 percent, the highest level since March 2009. However, the period of uncertainty arising from the Brexit is likely to persist before a deal is concluded in March 2019, with the European Union, the political and economic bloc it has affiliated to for more than four decades. The euro is also expected to appreciate against major currencies owing to monetary policy normalisation; the ECB is likely to move towards policy tightening, as inflation is closer to the Governing Council's target of 2 percent.

The Japanese yen is expected to depreciate due to a subdued inflation outlook; the Bank of Japan might concede that inflation could fall short of its 2 percent target for three more years, which would likely reinforce market expectations that the central bank is about to exit from ultra-easy policy. The Chinese renminbi is expected to depreciate, pressured by the rising threat of larger tariffs being imposed by the US on China. The worst period lies ahead for China; growth and exports are under pressure as the trade conflict with the US escalates. Overall, forecast movements of the SDR constituent currencies will result in a slight appreciation of the SDR against the US dollar (Chart 4.8).

The anticipated depreciation of the rand against major currencies is, however, expected to exert marginal downward pressure on the Pula against the SDR constituent currencies in the forecast horizon (Chart 4.9). The expected appreciation of the Pula against the rand should contribute positively to the domestic inflation outlook.

Chart 4.9: BWP against ZAR, USD and SDR



Source: Reuters and BoB calculations

Risks generally balanced

On the domestic front, contributing to downside inflation risks are the continuance of modest GDP growth and restrained increase in incomes. Externally, downside risks are associated with the protectionist policies by the US that have triggered retaliatory actions by China and the EU. These developments are likely to have a negative impact on global trade and, in turn, global investment and economic growth.

Upward risks to the inflation outlook relate to any unexpected large increase in administered prices or government levies and international commodity prices beyond current forecasts.

5. AUGUST 2018 MONETARY POLICY COMMITTEE DECISION

At the meeting held on August 23, 2018, the Monetary Policy Committee of the Bank of Botswana decided to maintain the Bank Rate at 5 percent. The outlook for price stability remains positive as inflation is forecast to be within the 3 – 6 percent objective range in the medium term. Inflation was unchanged at 3.1 percent between June and July 2018.

Subdued domestic demand pressures and the modest increase in foreign prices contribute to the positive inflation outlook in the medium term. This outlook is subject to upside risks emanating from the potential rise in administered prices, commodity prices and government levies and/or taxes beyond current forecasts. However, restrained growth in global economic activity, technological progress and productivity improvement, along with modest wage growth, present downside risks to the outlook.

Real GDP grew by 3.3 percent in the twelve months to March 2018, compared to 4 percent in the year to March 2017. The slower growth reflects a lower increase of 3.8 percent in non-mining activity, compared to 6 percent in the corresponding period in 2017. Moreover, the 0.3 percent decline in mining output also moderated overall growth. GDP is projected to expand in the short to medium term, driven largely by growth in the services sectors and recovery in mining activity, in line with the positive global economic prospects. Furthermore, the projected accommodative monetary conditions in the domestic economy and expansion in government expenditure, as well as relative stability in water and electricity supply, are expected to support expansion of economic activity in the non-mining sectors. Overall, the economy is expected to operate close to, but below full capacity in the medium term, thus posing no risk to the inflation outlook.

Global output growth was 3.7 percent in 2017 and is projected at 3.9 percent in 2018 and 2019, reflecting broad-based strengthening of economic performance. However, protectionist trade policies, potential build-up of financial vulnerabilities induced by easy financial conditions, geopolitical tensions and adverse weather could negatively affect the medium-term growth prospects. Regionally, GDP in South Africa is projected to expand by 1.2 percent in 2018, down from 1.3 percent in 2017, and is forecast at 1.9 percent in 2019. Growth prospects in South Africa are expected to remain subdued as output projections are weighed down by the widening fiscal account deficit and a slow implementation of reforms.

The current state of the economy and the outlook for both domestic and external economic activity suggest that the prevailing monetary policy stance is consistent with maintaining inflation within the objective range of 3 – 6 percent in the medium term. Consequently, the Monetary Policy Committee decided to retain the Bank Rate at 5 percent.

MPC meetings for the remainder of the year are scheduled for October 22, 2018 and December 4, 2018.