

3.3 Monetary developments

Lower growth in banking sector assets

Annual growth in banking sector assets decreased from 6.5 percent in January 2018 to 4 percent in February 2018 (Chart 3.5). This was partly due to a decrease in the Bank of Botswana's deposits and a slowdown in the growth of balances due from foreign banks.

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



Source: Commercial Banks

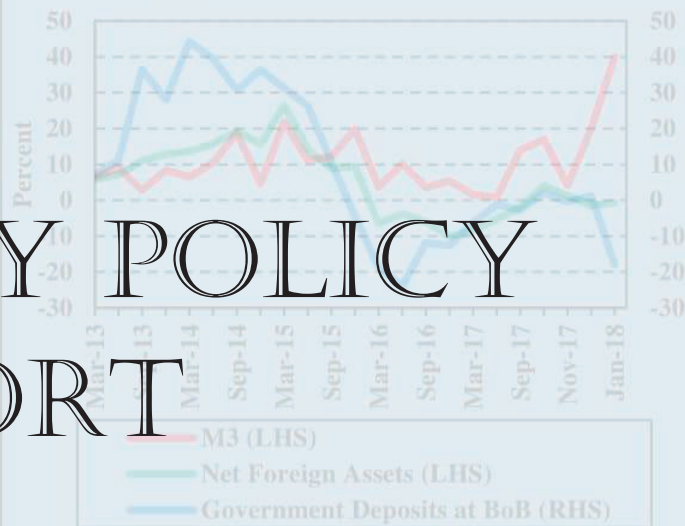
Credit growth remains stable

Annual growth in commercial banks' credit to the business sector remained the same (4.9 percent) in February 2018 as in the previous month (Chart 3.6). This was reflected by stable growth in lending to the business sector (mainly due to the steady growth in credit extended to resident businesses) and a negligible decrease of 0.1 percent in growth in lending to households.

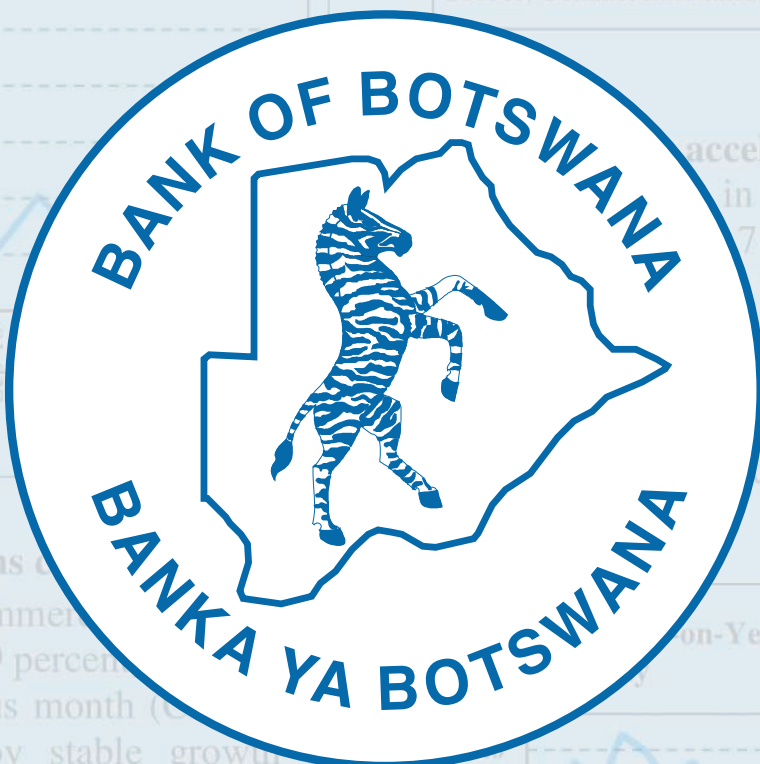
Bank Rate unchanged

At the August 2017 MPC meeting, the Bank Rate was maintained at 5.5 percent on account of a positive medium-term inflation outlook, which reflected moderate domestic demand pressures and the modest increase in foreign prices. The policy stance was also assessed to be supportive of economic activity.

Chart 3.: Year-on-Year Growth in Money Supply



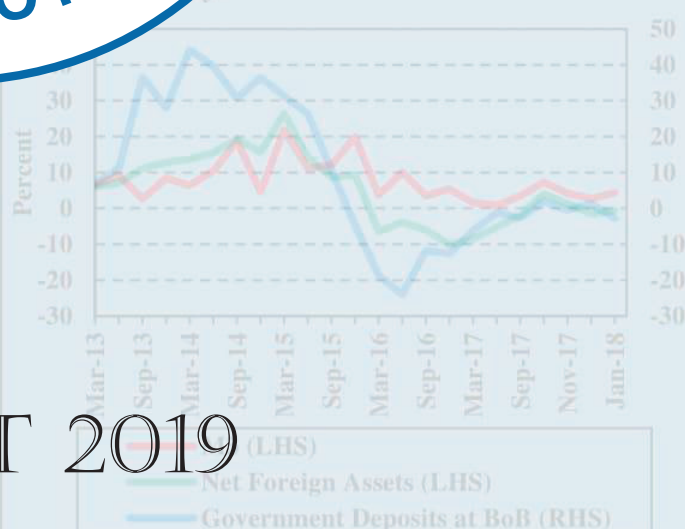
Source: Commercial Banks, Bank of Botswana



Money supply accelerates

Annual growth in money supply (M3) increased to 40 percent in December 2017 and 47 percent in January 2018 (Chart 3.7). This was due to the expansionary effect of the growth of Government Deposits at Botswana, which was offset by a decline in growth of net

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



Source: Commercial Banks, Bank of Botswana

AUGUST 2019
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 October meetings of the 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 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, which seeks to maintain a stable real effective exchange rate (REER) conducive for macroeconomic stability and 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 to, and engaging in Repo/Reverse Repo transactions with, commercial banks (primary dealers), as well as adjustment of the Primary Reserve Requirement 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); the two Deputy Governors; General Manager responsible for banking and currency management; 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 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 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. 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 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 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

In 2019, monetary policy is implemented in the context of a favourable medium-term inflation outlook, associated with moderate domestic demand resulting from the restrained increase in personal incomes and expected modest increase in foreign prices. However, the current state of the economy and the outlook for both domestic and external economic activity provide a scope for easing monetary policy to support economic activity. Thus, the Bank Rate was reduced by 25 basis points from 5 percent to 4.75 percent at the August 2019 MPC meeting, the first policy change since 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 considerable upward adjustment in administered prices and any increase in international food and oil prices as well as accelerated government spending beyond current forecasts. There are, however, downside risks associated with prospects of weak global economic activity (exacerbated by the deepening trade war between the United States (US) and China), the tendency of technological progress to lower costs and prices, the potential fall in international commodity prices, as well as the continuance of modest domestic economic growth.

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 stability without undermining economic activity.

Headline inflation averaged 2.6 percent in the second quarter of 2019, a decline from an average of 3.3 percent in the second quarter of 2018, largely reflecting the base effects associated with the upward adjustments in the public transport fares, fuel prices and electricity tariffs in the second quarter of 2018. Inflation is expected to remain slightly below the lower bound of the Bank's objective range in the second half of 2019, but to revert within the objective range in the first quarter of 2020.

Gross domestic product (GDP) grew by 4.4 percent in the twelve months to March 2019, higher than the 3.8 percent growth in the corresponding period in 2018, mainly attributable to the continued good performance in non-mining sectors and the recovery in mining output. Output growth is projected at 4.2 percent and 4.8 percent in 2019 and 2020, respectively, reflecting the anticipated growth in mining output, the prevailing accommodative domestic monetary conditions and expected increase in government spending. In addition, improvements in water and electricity supply, as well as reforms to further improve the business environment, would be positive for economic activity generally. However, output is projected to remain below potential in the forecast horizon.

Annual growth in commercial bank credit decelerated to 6.5 percent in June 2019 from 7.6 percent in the corresponding period in 2018, reflecting, in part, subdued growth in lending to the business sector, including decreased utilisation of existing credit facilities and loan repayments by some companies in manufacturing, finance and trade industries.

At the end of June 2019, foreign exchange reserves amounted to P71.8 billion, a decrease of 3.4 percent from P74.3 billion in June 2018; this is equivalent to 14.6 months of import cover of goods and services. The decrease reflects, among others, revaluation losses arising from movement in exchange rates of the currencies the foreign exchange reserves are held in. In addition, the current account of the balance of payments recorded a deficit of P815 million in the first quarter of 2019, due to a negative balance in merchandise trade and income account balances during the period.

The nominal effective exchange rate (NEER) of the Pula appreciated by 0.1 percent in the twelve months to August 2019, consistent with the transition from an annual downward rate of crawl of 0.3 percent

implemented in 2018 to an upward annual rate of crawl of 0.3 percent, effective January 2019. The Pula appreciated against the South African rand, but depreciated against the SDR in the twelve months to August 2019. The Pula appreciated against most of the SDR constituent currencies, influenced by the performance of the rand against those currencies. Meanwhile, in the year to July 2019, the real effective exchange rate (REER) appreciated by 0.2 percent, because of higher inflation in Botswana than in trading partner countries, against the background of a relatively stable NEER.

Global economic output grew by 3.6 percent in 2018 and it is anticipated to ease to 3.2 percent in 2019, mainly due to the slowdown in economic activity associated with heightened trade tensions between the US and China, the uncertainty surrounding Brexit, as well as the weaker than expected economic expansion in emerging markets. US GDP growth slowed from 3.1 percent in the first quarter of 2019 to 2.1 percent in the second quarter, mainly influenced by the decrease in private inventory investment and exports. GDP in the United Kingdom (UK) contracted for the first time since 2012 in the second quarter of 2019, reflecting decline in inventories and the shut downs in the car industry. Economic activity weakened in the emerging market economies, due to trade tensions, tightening financing conditions, capital outflows and volatile oil prices. In South Africa, output contracted by an annualised 3.2 percent in the first quarter of 2019, reflecting the negative effects of Eskom's power cuts on the manufacturing and mining sectors, as well as weaker business and consumer confidence.

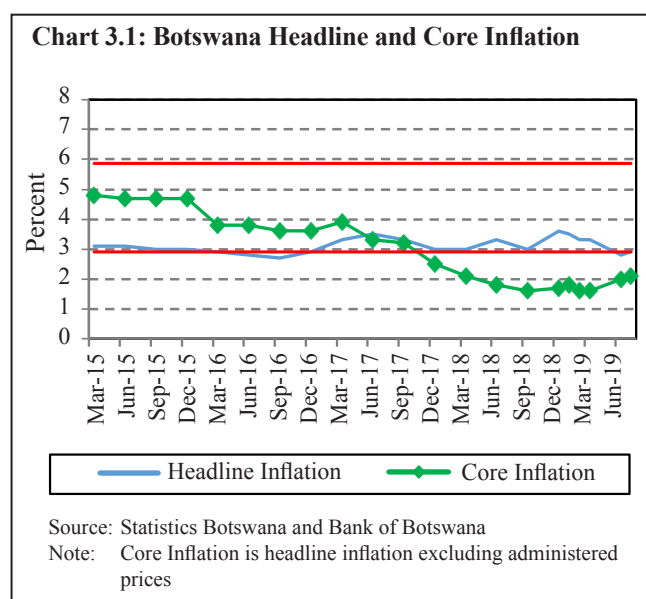
The global rough diamond price index decreased in the second quarter of 2019 against the backdrop of deteriorating consumer and investor sentiment, excess supply of smaller diamonds and underperformance in the Indian consumer market. International oil prices (Brent crude and OPEC) increased to above USD65 per barrel in the second quarter of 2019 reflecting the decline in US crude inventories and continued tensions in the Middle-East, as well as compliance by oil producers to cut production by 1.2 million barrels per day. Meanwhile, the United Nation's Food and Agriculture Organisation (FAO) food price index declined in the second quarter of 2019, as prices of cereals and vegetable oil groups decreased.

3. RECENT ECONOMIC DEVELOPMENTS

3.1 Inflation

Headline inflation decreases in the second quarter of 2019

Headline inflation averaged 2.6 percent in the second quarter of 2019 and was lower than the 3.3 percent average inflation in the second quarter of 2018 (Chart 3.1), mostly reflecting the base effects associated with the upward adjustments in the public transport fares, fuel prices and electricity tariffs in the second quarter of 2018.¹ Inflation was 2.9 percent in July 2019 (Table 3.1).



Trimmed mean core and inflation excluding food and fuel decrease

The trimmed mean inflation (CPITM) decreased to 2.6 percent in the second quarter of 2019, from 3.1 percent in the second quarter of 2018, while core inflation, excluding administered prices (CPIXA), averaged 1.9 percent compared to 1.8 percent in the same period (Chart 3.2). Inflation excluding food and fuel (CPIXFF) averaged 1.6 percent in the second quarter of 2019, lower than the 3.7 percent in the corresponding quarter in 2018 (Table 3.1), reflecting annual price increase for “miscellaneous goods and services” and “communication” in the same period. In July 2019, CPIXA and CPIXFF were 2.1 percent and 2 percent, respectively, while CPITM was 2.6 percent.

¹ These increases added approximately 0.96 percentage points to headline inflation in the second quarter of 2018, which was, however, partly offset by the reduction in voice call tariffs, which subtracted 0.4 percentage

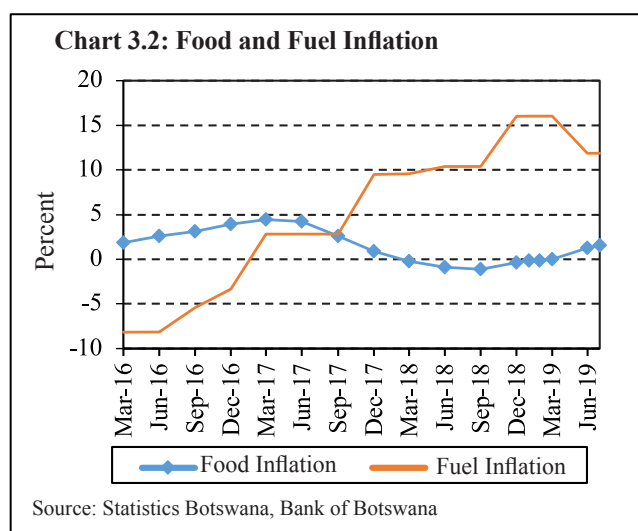


Table 3.1: Annual Price Changes for Categories of Goods and Services (Percent)

| Category of commodities | Basket Weights | July 2019 | Q2 2019 | Q2 2018 |
|---|----------------|------------|------------|------------|
| Food and non-alcoholic beverages | 13.6 | 1.6 | 0.9 | -0.4 |
| Alcoholic beverages and tobacco | 4.3 | 3.6 | 2.8 | 0.6 |
| Clothing and footwear | 6.0 | 0.9 | 1.1 | 2.1 |
| Housing, water, electricity, gas and other fuels | 17.5 | 1.8 | 1.7 | 3.4 |
| Furnishing, h/h equipment and routine maintenance | 4.9 | 2.3 | 1.8 | 2.1 |
| Health | 3.4 | 1.1 | 1.1 | 1.2 |
| Transport | 23.4 | 6.0 | 7.1 | 6.7 |
| Communications | 6.9 | 0.0 | -6.3 | -1.9 |
| Recreation and culture | 2.8 | 0.1 | 0.1 | 2.0 |
| Education | 4.6 | 3.2 | 3.2 | 5.5 |
| Restaurants and hotels | 3.7 | 2.2 | 2.4 | 3.6 |
| Miscellaneous goods and services | 9.0 | 5.0 | 4.8 | 8.2 |
| Annual Inflation (All items) | 100.0 | 2.9 | 2.6 | 3.3 |
| CPITM | | 2.6 | 2.6 | 3.1 |
| CPIXA | | 2.1 | 1.9 | 1.8 |
| CPIXFF | | 2.0 | 1.6 | 3.7 |

Source: Statistics Botswana and Bank of Botswana calculations

Note: The basket weights have been revised based on the results of the 2015/16 Botswana Multi-Topic Household Survey

points from inflation, resulting in a net impact of 0.56 percentage points to inflation in the same quarter.

Box 1: Rebasing and Revision of the Consumer Price Index (CPI) Basket

CPI rebasing entails changing the old base year used for calculating basket weights of the components of the CPI basket to a new and more recent base year, and this instance also involves changing the basket weights to take into account the change in the consumption pattern. CPI rebasing eliminates the influence of historical trends on the current measurement of inflation. In addition, it provides an opportunity to incorporate new data sources and methodological updates which can result in further revisions.

Statistics Botswana rebased the CPI from September 2016 to December 2018. Therefore, effective January 2019, the price indices are on the new base year. Consequently, the consumer basket composition and item weights have been adjusted based on the results of the 2015/16 Botswana Multi-Topic Household Survey. Furthermore, basket items were increased from 393 to 400, while the categorisation of the items was maintained at 51 sections and 12 commodity groups. The increase in the basket items and adjustment of weights reflect changes in the consumption pattern. Thus, items that are not available in the market were removed from the CPI basket, while new items were included (Table 3.2).

The weights of items and category groups in the basket reflect their relative importance in relation to the entire basket (Table 3.3). *Alcoholic beverages and tobacco, food and non-alcoholic beverages, transport and communications* experienced the largest revisions. Generally, there has been a substitution from goods to services in the current consumption basket, in line with changes in sectoral influences on GDP and growth in the average income. Thus, the weights of services categories, such as *transport, communications, housing, water and electricity, education, and restaurants and hotels* have been revised upwards, and downwards for goods such as *food and non-alcoholic beverages and alcoholic beverages and tobacco*.

Table 3.2: New and Removed Items from CPI Basket

| New Items | Removed Items |
|--|--|
| <p>1) Food and non-alcoholic beverages</p> <ul style="list-style-type: none"> a. Basmati rice 1kg b. Bread roll (sold loose) c. Instant noodles 77g d. Pork, loin chop per kg e. Tuna in vegetable oil 125g f. Liquid yoghurt (yogo fun) 250g g. Olive oil, extra virgin h. Fresh cucumber i. Fresh green pepper <p>2) Alcoholic beverages and tobacco</p> <ul style="list-style-type: none"> a. Cigarettes, slim vogue <p>3) Health</p> <ul style="list-style-type: none"> a. Consultation with Gynaecologist b. Consultation with Pediatrician <p>4) Transport</p> <ul style="list-style-type: none"> a. Replacement of brake pads, labour only b. Car wash (motor car) c. Railway passengers' fee (Gaborone to Francistown) <p>5) Communications</p> <ul style="list-style-type: none"> a. Mobile data pass (1 GB; a month) b. Phone repair, replacement of screen for Samsung S6 c. Telephone charges/rate to mobile (all mobile) | <p>1) Clothing and footwear</p> <ul style="list-style-type: none"> a. Babies disposable nappies (pampers; 0 to 3kg) <p>2) Housing, water, electricity and other fuels</p> <ul style="list-style-type: none"> a. Water: 10kl per month in cities and towns <p>3) Furnishing, household equipment and routine maintenance</p> <ul style="list-style-type: none"> a. Non-electric iron <p>4) Health</p> <ul style="list-style-type: none"> a. Painkillers, Grandpa small packets <p>5) Recreation and culture</p> <ul style="list-style-type: none"> a. Membership fee, one adult, Notwane club b. Entrance to night clubs (Saturday evening, one man) <p>6) Miscellaneous goods and services</p> <ul style="list-style-type: none"> a. Hairdressing set |

Source: Statistics Botswana

Table 3.3: Basket Weights

| Category of Commodities | Weights | |
|---|----------------|---------------|
| | New | Old |
| Transport | 23.43 | 20.65 |
| Housing, water, electricity and other fuels | 17.45 | 14.90 |
| Food and non-alcoholic beverages | 13.55 | 16.51 |
| Miscellaneous goods and services | 9.01 | 10.55 |
| Communications | 6.94 | 4.27 |
| Clothing and footwear | 5.95 | 6.27 |
| Furnishing, household equipment and routine maintenance | 4.85 | 6.39 |
| Education | 4.60 | 3.34 |
| Alcoholic beverages and tobacco | 4.34 | 7.83 |
| Restaurants and hotels | 3.66 | 2.76 |
| Health | 3.38 | 3.62 |
| Recreation and culture | 2.82 | 2.92 |
| Annual Inflation (All Items) | 100.00 | 100.00 |

Source: Statistics Botswana

3.2 Recent economic developments in Botswana

Modest GDP growth in the year to March 2019

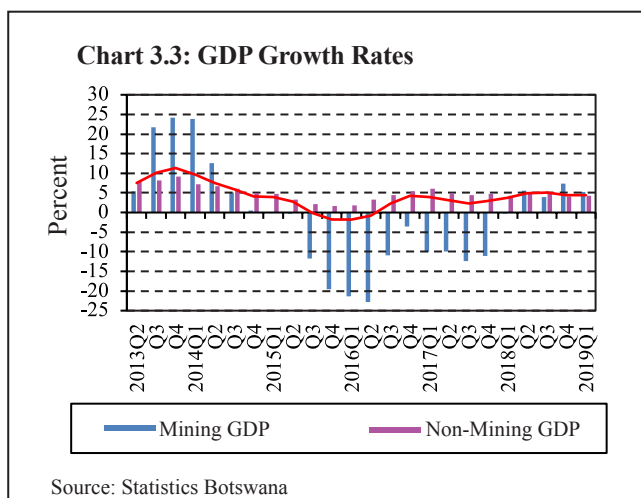
Real GDP grew by 4.4 percent in the twelve months to March 2019, compared to a lower expansion of 3.8 percent in the corresponding period in 2018 (Table 3.4). This was mainly attributable to the continued good performance of the non-mining sectors and recovery in mining output. Mining output expanded by 5.3 percent in the year to March 2019, compared to a contraction of 0.3 percent in the corresponding period in 2018. The improved mining output was driven by the diamond industry and the return to full production of soda ash at the Botash Mine, following a maintenance programme of the mine in the second quarter of 2017. Other mining sub-sectors also registered positive growth rates in the period under review, with a notable increase of 7.2 percent in copper output, mainly reflecting the base effects associated with the closure of BCL mine in October 2016, and resumption of production by the Mowana Mine².

Non-mining GDP grew by 4.3 percent in the year to March 2019, the same growth rate as in the corresponding period in the previous year. The overall expansion in non-mining GDP was mainly supported by trade, hotels and restaurants (5.2 percent)³ and finance and business services (5.1 percent). Water and electricity grew by 7 percent as local electricity production increased, although the sector's contribution to total GDP is marginal (nearly one percent).

Table 3.4: Real Annual GDP Growth by Sector and Expenditure (Percent)

| | 2018Q1 | 2019Q1 |
|-------------------------------|------------|------------|
| Total GDP | 3.8 | 4.4 |
| By Sector | | |
| Mining | -0.3 | 5.3 |
| Non-Mining | 4.3 | 4.3 |
| Agriculture | 2.2 | 2.8 |
| Manufacturing | 3.2 | 3.5 |
| Water and Electricity | 58.8 | 7.0 |
| Construction | 3.4 | 3.5 |
| Trade, Hotels and Restaurants | 4.0 | 5.2 |
| Transport and Communications | 5.2 | 6.2 |
| Finance and Business Services | 4.2 | 5.1 |
| General Government | 1.9 | 3.2 |
| Social and Personal Services | 3.1 | 3.6 |
| By Expenditure | | |
| Government Final Consumption | 2.3 | 3.3 |
| Household Final Consumption | 7.6 | 2.9 |
| Gross Fixed Capital Formation | -6.4 | 7.5 |
| Exports | -16.7 | 10.0 |
| Imports | -15.8 | 16.1 |

Source: Statistics Botswana and Bank of Botswana calculations



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

Diamond production decreased in the second quarter of 2019

Debswana produced 5.7 million carats of diamonds in the second quarter of 2019, a decrease of 8.9 percent compared to the same period in 2018, mainly due to lower production at Orapa Mine,⁴ which decreased by 23.3 percent in the second int

² Mowana Mine had started producing copper effective April 2017, and later suspended its operations in November 2018, due to lack of capital. Therefore, copper production in Botswana remains uncertain for 2019, given that the Khoemacau Copper Mine is only expected to start production in the second quarter of 2021.

³ This sector incorporates elements of tourism.

⁴ Orapa output constitutes production from Orapa, Damtshaa and Letlhakane mines.

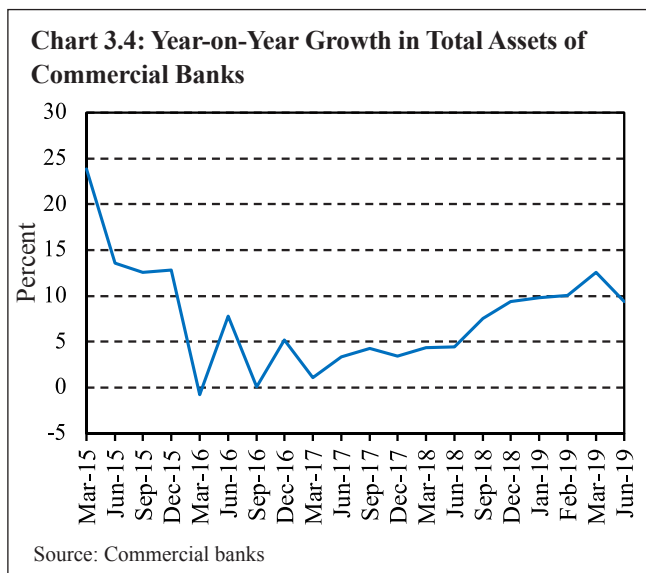
the second quarter, following a planned plant shut down. Production at Jwaneng Mine increased by 6.5 percent in the same period.

Lucara Diamond Corporation (Karowe Mine) output increased by 34.1 percent to 109 312 carats⁵ in the second quarter of 2019, from 81 507 carats in the corresponding period in 2018. The increase in production is attributable to improved efficiency in the recovery of smaller sized diamonds. During the second quarter of 2019, a total of 225 special stones⁶ (single diamonds larger than 10.8 carats) were recovered, including ten diamonds greater than 100 carats. Special stones accounted for 8.1 percent of total carats recovered during the period. Overall, for 2019, Karowe Mine anticipates to produce between 375 000 and 420 000 carats, higher than 366 086 carats recovered in 2018.

3.3 Monetary developments

Growth in banking sector assets slows in June 2019

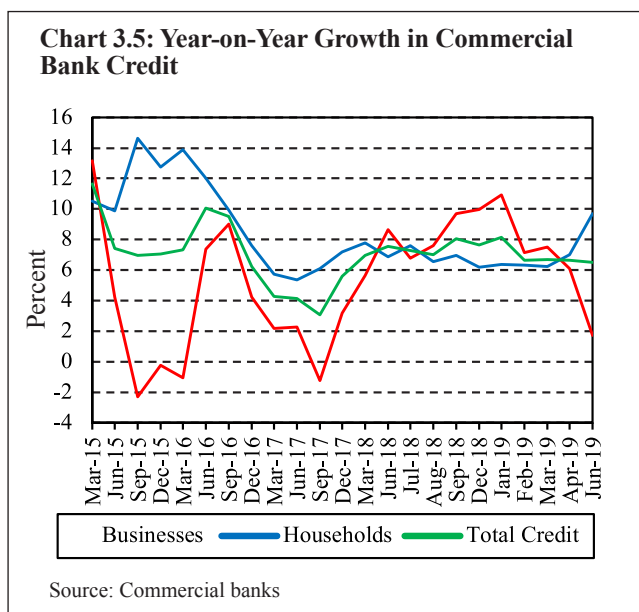
Annual growth in banking sector assets decelerated from 11.1 percent in the twelve months to June 2018 to 9.4 percent in the corresponding period in 2019 (Chart 3.4). This was due to the overall decrease in the growth of loans and advances, which account for the largest proportion of commercial banks' assets as well as the growth in balances due from domestic banks and those at Bank of Botswana.



⁵ This includes 8 172 carats recovered from the re-processing of tailings from previous milling.

Credit growth decelerates in June 2019

Year-on-year growth in commercial bank credit eased to 6.5 percent in the twelve months to June 2019, from 7.6 percent in the corresponding period in 2018 (Chart 3.5). The lower growth in commercial bank credit was due to the subdued growth in lending to the business sector because of decreased utilisation of existing credit facilities and loan repayments by some companies in manufacturing, finance and trade industries. Meanwhile, some parastatals increased utilisation of their credit facilities in June 2019. The growth in lending to households increased due to higher demand of personal loans influenced by the recent increase in public services salaries.

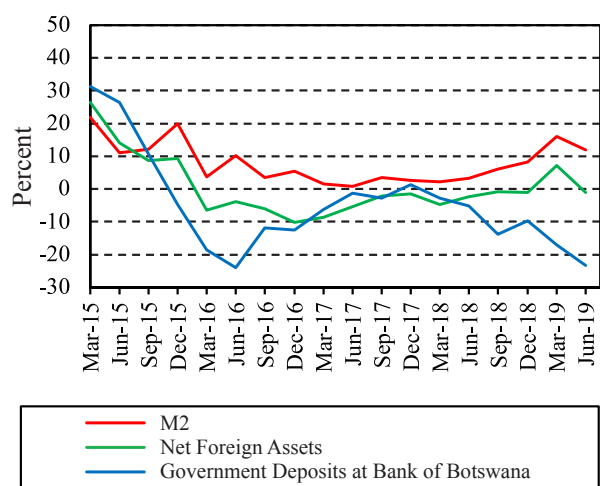


Money supply growth accelerates in June 2019

Annual growth in money supply (M2) accelerated from 3.4 percent in the twelve months to June 2018 to 11.9 percent in the corresponding period in 2019 (Chart 3.6). This was due to the decline in government deposits at Bank of Botswana, as well as the slight decrease in net foreign assets.

⁶ This includes the largest diamond ever recovered at Karowe Mine in April 2019 (Sewelô), weighing 1 758 carats.

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



Source: Commercial banks, Bank of Botswana

The 3-month BoBC stop-out yield increases in the second quarter

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. The 7-day BoBC stop-out yield was constant at 1.62 percent in May and June 2019. However, the 3-month BoBC stop-out yield increased from 1.54 percent in the second quarter of 2018 to 1.72 percent in the corresponding period in 2019. In July 2019, the BoBC stop-out yields for the 7-day BoBC and 3 - month BoBC increased to 1.63 percent and 1.73 percent, respectively. Meanwhile, the real rate of interest for the 7-day BoBC was -0.96 percent and -1.15 percent in May and June 2019, respectively. Meanwhile, the real interest rate for the 3-month BoBC increased from -1.67 percent in the second quarter of 2018 to -0.89 percent in the same period in 2019, reflecting the decrease in the average inflation rate. However, in July 2019, the real rate of interest for the 7-day BoBC and 3-month BoBC decreased to -1.23 percent and -1.14 percent, respectively, on account of the increase in inflation. Box 2 discusses reforms to monetary operations.

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 this respect, on April 30, 2019, the Bank introduced the 7-day BoBC as the main instrument for conducting monetary operations to replace the 14-day BoBC. The move to the 7-day BoBC was to enable a shorter and simpler forecasting horizon for liquidity management by both the Bank and commercial banks, resulting in more accurate outcomes. In turn, it is also expected to provide a solid base for the starting point of the monetary policy transmission mechanism, supporting the extension of the policy signal along the yield curve.

The Bank will adopt “reserves averaging” in the determination of the Primary Reserves Requirement (PRR). Under “reserves averaging”, commercial banks do not have to meet the PRR daily but, rather, fulfil this statutory requirement on an average basis over the maintenance period which is, in Botswana’s case, a calendar month. Reserves averaging, which is used in numerous jurisdictions, has been shown to improve liquidity management by commercial banks, foster more effective resource allocation through the interbank market and reduce the demand for excess reserves held for precautionary purposes.

Specifically, reserves averaging will involve the following features:

- As is currently the case, at the beginning of each maintenance period, commercial banks will be advised of their reserve requirements for the coming period.
- The PRR and current accounts will continue to be kept separately, but with banks allowed to move funds between the two accounts.
- At the end of each maintenance period, a bank complies if the average end-of-day balances on its required reserves account are at least equal to the PRR as computed by the Bank.
- If there is non-compliance, a fine will be applied based on the average daily deficit and in line with the Bank of Botswana Act (Chapter 55:01; Part VII; 40 (5))

The introduction of reserves averaging requires input and cooperation from commercial banks and, in that regard, consultation with the commercial banks has been concluded; implementation with effect from the fourth quarter of 2019.

Moreover, further consultations have been undertaken with commercial banks on other possible changes to monetary operations. This includes whether the Bank Rate or the BoBC rate is more relevant as the “anchor policy rate” for policy transmission purposes. The consultation process also includes benchmarking against other major central banks in the region. The objective of these refinements is to enhance the potency of the policy rate in the transmission of monetary policy signals, as well as its influence on subsequent market reaction and posture. Furthermore, there is need to spur the development and efficacy of the money markets, for the purposes of effective policy transmission, as well as management, access and flow of liquidity among the commercial banks.

Finally, alongside these measures designed to ensure better structural alignment of short-term market rates and desirable policy transmission, any notional ceiling on the issuance of BoBCs has been lifted. This approach allows greater scope and flexibility for unconstrained and, therefore, effective liquidity absorption by the central bank in response to market developments.

3.4 Asset market

Property market remains weak in the first quarter of 2019

According to the latest Riberry Report ⁷ (first quarter of 2019), the residential market for the lower-end and medium-cost properties continued to have good demand and supply compared to the higher-end residential housing, where the demand was weaker. Overall, the average price for residential property sold in the first quarter of 2019 increased by 11.1 percent to P852 529 compared to the previous quarter, reflecting the higher demand for the lower-end and medium-cost residential housing.

The residential rental market weakened in the first quarter of 2019 compared to the previous quarter, as indicated by the fall in rentals for the upper-end properties and weaker demand for middle-end properties. However, demand and supply of property was good at the lower-end of the rental market.

Looking ahead, the demand for lower-end prime located residential housing is expected to improve in the short term.

The market for office space remains weak due to increasing supply from completed construction developments, such as the Botswana Unified Revenue Service building in 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 decentralised office locations, 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.

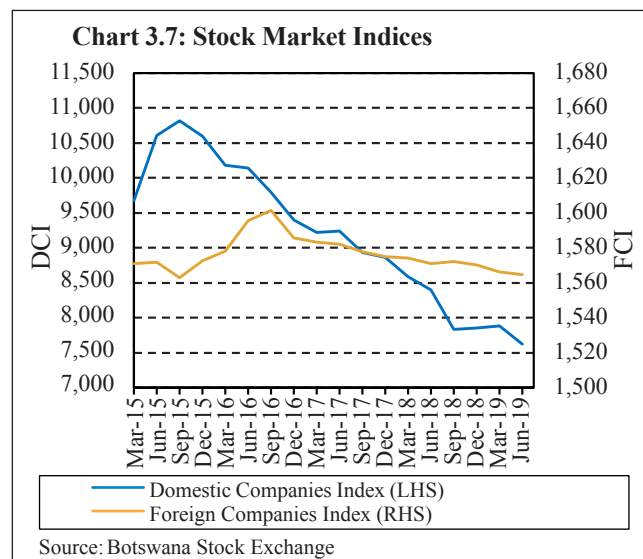
The supply for office space is likely to increase further going forward, given the ongoing construction projects and planned office buildings at the CBD, such as by the Botswana Housing Corporation and Water Utilities Corporation. These will further exert downward pressure on rentals, especially

in the decentralised office locations. Meanwhile, the demand for retail space remains fair across all market segments, with proposed major shopping centres in the CBD and Block 10 (Gaborone) 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 bigger warehouse space has decreased, while the demand has improved. The demand for prime location industrial space is expected to improve, going forward.

Stock market index declines

The Domestic Companies Index (DCI) declined by 8.9 percent in the twelve months to July 2019 compared to a reduction of 8.3 percent in the year to July 2018 (Chart 3.7). The decline was mainly due to the lower share prices for Stanchart, Botswana Telecommunications Corporation Limited and Letshego, which fell by 60.2 percent, 26.1 percent and 26.6 percent, respectively, in the same period. According to Stockbrokers Botswana⁸, the continuous decline in the DCI was reflective of the sluggish corporate earnings due to restrained economic environment.

The Foreign Companies Index (FCI) declined by 0.3 percent in the year to July 2019, compared to a decline of 0.7 percent in the corresponding period ending in July 2018 (Chart 3.7). This was largely attributed to the year-on-year decrease in share price for Tlou (-48.7 percent), BOD (-25 percent) and Lucara (-15.8 percent), on account of low trading activity and liquidity.



⁷ This is a quarterly report produced by independent valuers, Riberry Botswana (Pty) Ltd.

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

In the same token, local investments by pension funds in the Botswana Stock Exchange also declined in the year to July 2019 by 2 percent, albeit a slight improvement from the 5.1 percent decrease in July 2018. Investments in the offshore equities also declined by 3.1 percent in July 2019 from a contraction of 2.8 percent in July 2018.

3.5 Balance of payments

The current account records a deficit in the first quarter of 2019

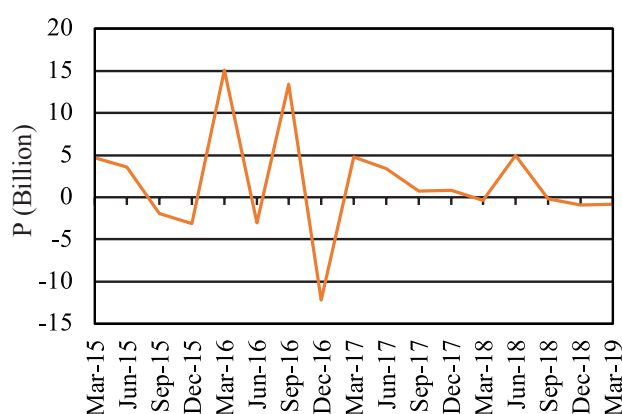
The current account recorded a deficit of P815 million in the first quarter of 2019, compared to a deficit of P330 million in the first quarter of 2018 (Chart 3.8). The larger deficit was due to negative balance in merchandise trade and income account balance during the period.

The negative trade balance was mainly attributable to an increase of 23.3 percent in diamond imports, compared to an increase of 9.5 percent in diamond exports. The increase in diamond imports was due to diamonds aggregation activities, which includes the importation and re-exportation of the diamonds. Therefore, the negative trade balance does not reflect substantial growth in imports for domestic consumption, and since the associated transactions are mainly conducted offshore, they have limited implications on the domestic macroeconomic policies. Imports of vehicles and transport equipment also contributed significantly to the trade deficit. This covers equipment used for construction, mining and agriculture, which should raise domestic productive capacity going forward.

The negative balance in the income account resulted from an increase in payment of investment income in the form of, among others, dividends and interest to foreign investors than receipts by locals from their investments abroad.

In general, persistent current account deficits, mainly fuelled by consumption rather than productive investment expenditure may be detrimental to the macroeconomic stability of the country. However, in the case of Botswana, there is a large component of developmental and capital imports that should support future growth prospects.

Chart 3.8: Quartely Current Account Balance



Source: Bank of Botswana

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

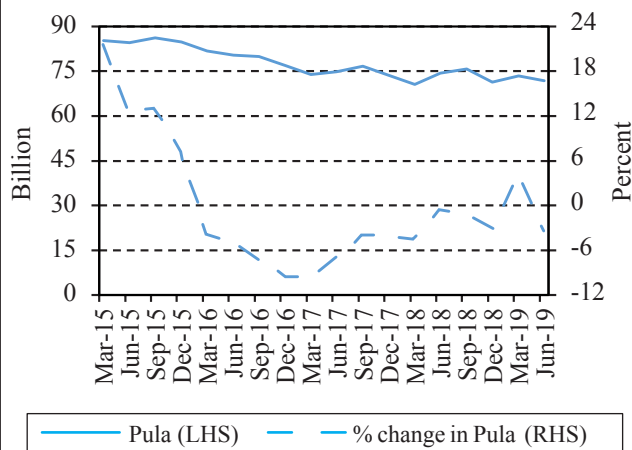
The overall financial account had an estimated net outflow of P8.4 billion during the first quarter of 2019 compared to a net inflow of P5.1 billion in the first quarter of 2018. The outflow is attributable to, among others, an increase in offshore investments, particularly, investment in equity securities. Foreign markets offer more diversified portfolios implying a better choice of investment instruments and returns, which leads to an accumulation of more offshore assets. Thus, the net capital outflow is not instigated by capital flight, but rather, a lack of domestic financial instruments due to the underdeveloped capital markets in Botswana and, in the recent past, falling returns and loss of capital for investments in the Botswana Stock Exchange.

Foreign exchange reserves decrease

As at the end of June 2019, the foreign exchange reserves amounted to P71.8 billion, a decrease of 3.4 percent from P74.3 billion in June 2018 (Chart 3.9). The decrease was, among others, a result of drawdown on foreign exchange reserves.

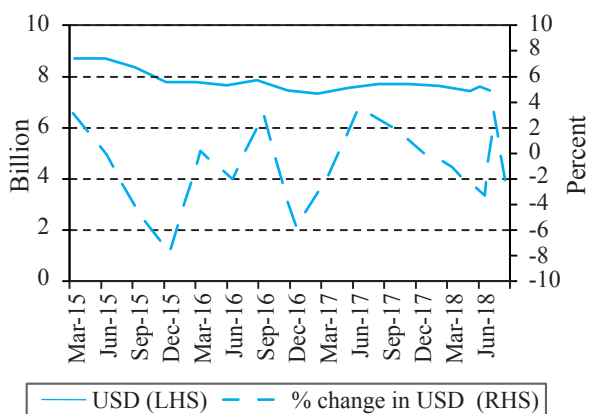
In foreign currency terms, the level of reserves decreased by 4.2 percent from USD7.1 billion in June 2018 to USD6.8 billion in June 2019 (Chart 3.10). The reserves also decreased by 3.9 percent from SDR5.1 billion to SDR4.9 billion over the same period. The decrease in foreign currencies also reflects revaluation losses arising from movement in exchange rates of the currencies the foreign exchange reserves are held in. The level of foreign exchange reserves as at the end of June 2019 was equivalent to 14.6 months of import cover of goods and services.

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



Source: Bank of Botswana

Chart 3.10: Foreign Exchange Reserves in US Dollar and Annual Percentage Change



Source: Bank of Botswana

3.6 Exchange rate developments

For 2019, the Bank's implementation of the exchange rate policy entails basket weights of the Pula at 45 percent South African rand and 55 percent SDR, and a 0.3 percent upward annual rate of crawl. The upward rate of crawl seeks to maintain the stability of the REER as domestic inflation was projected to be around the lower end of the Bank's inflation objective range and slightly lower than the trading partner countries' forecast average inflation.

Bilaterally, the Pula appreciated by 1.1 percent against the South African rand and depreciated by 0.7 percent against the SDR in the twelve months to August 2019 (Chart 3.11). In the same period, against the SDR constituent currencies, the Pula depreciated by 7.2 percent against the Japanese yen and 3.1 percent against the US dollar, while it appreciated by 3.6 percent against the British pound, 2.5 percent against the euro and 1.3 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. Notably, in the same review period, the rand depreciated by 1.8 percent against the SDR. Against its constituent currencies, the rand depreciated by 8.2 percent against the Japanese yen and 4.2 percent against the US dollar, while it appreciated by 2.5 percent against the British pound, 1.4 percent against the euro and 0.2 percent against the Chinese renminbi.

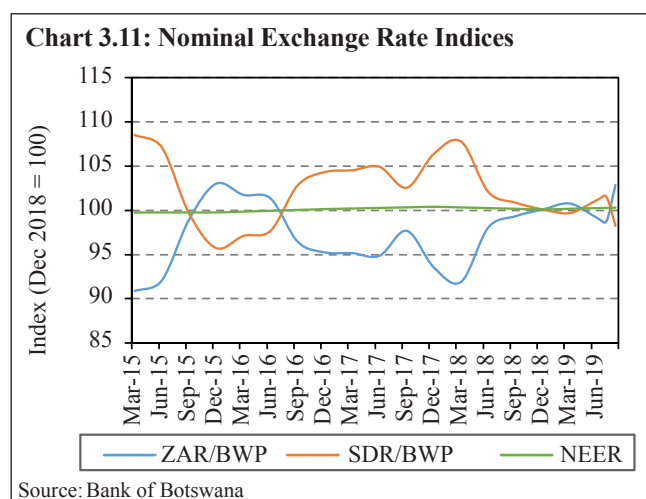
The South African rand, along with other emerging market currencies, depreciated against the major currencies due to global risk aversion on the back of the escalating trade war between the US and China, which has resulted in subdued global markets. The trade tension between the two major economies continues to create policy uncertainty, thereby exposing emerging markets to external vulnerabilities, including dampening the demand for emerging market currencies in favour of safe-haven currencies. Furthermore, the rand was undermined by Moody's Investors Service report which gave

The overall balance of payments was in deficit of P5.4 billion in the twelve months to June 2019. The deficit was due to slower growth in exports, while the demand for capital and consumption imports was sustained at a relatively high level, as well as capital flows abroad to afford larger portfolio choices and return opportunities (given limited opportunities and undeveloped domestic capital market).

The overall balance of payments deficit relative to GDP⁹ is comparatively small at 2.8 percent and judged to be sustainable given the state of the economy, macroeconomic policy frameworks and future prospects.

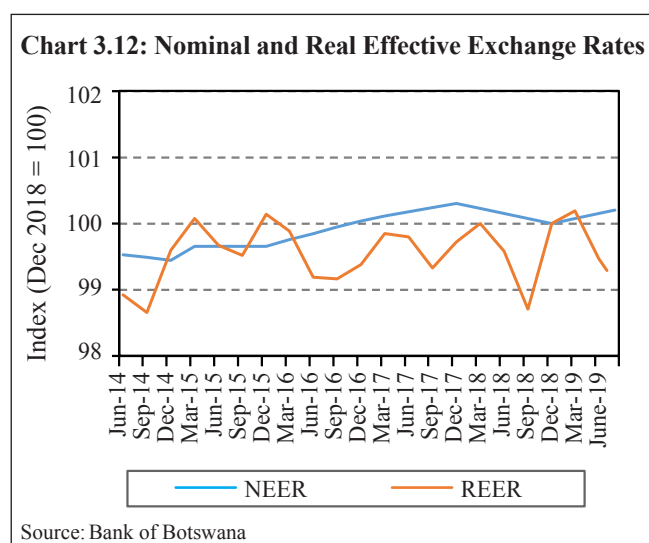
⁹ GDP at current prices as at end of 2018.

a warning over the South African government's proposal to offer R59 billion¹⁰ (USD4.25 billion) in additional support to the cash strapped power utility Eskom.



NEER appreciated in August 2019

The NEER of the Pula appreciated by 0.1 percent in the twelve months to August 2019 (Chart 3.12), consistent with the transition from an annual downward rate of crawl of 0.3 percent implemented in 2018 to an upward annual rate of crawl of 0.3 percent, effective January 2019.



REER appreciated in July 2019

The REER appreciated by 0.2 percent in the twelve months to July 2019 (Chart 3.12), due to higher inflation in Botswana (2.9 percent) than in trading

partners (2.7 percent) against the background of a relatively stable NEER. With respect to bilateral movements against the Pula basket currencies, the real Pula exchange rate (using headline inflation) appreciated by 1.9 percent against the South African rand and depreciated by 1.1 percent against the SDR. Regarding the SDR constituent currencies, the Pula depreciated by 4.5 percent against the Japanese yen, 3.4 percent against the Chinese renminbi and 3.3 percent against the US dollar, while it appreciated by 4.1 percent against the British pound and 2.3 percent against the euro.

3.7 Recent global economic developments

Global growth modest

According to the July 2019 World Economic Outlook (WEO) Update, global output growth for 2019 is expected to be 3.2 percent, lower than the 3.6 percent estimate for 2018 (Table 3.5). Growth in the first half of 2019 was adversely affected by heightened trade tension between the US and China¹¹, uncertainty surrounding Brexit, as well as weaker-than-expected economic activity in emerging market and developing economies.

Growth in US economic activity decelerates in the second quarter of 2019

In the US, output growth decreased from 3.1 percent in the first quarter of 2019 to 2.1 percent in the second quarter, but was higher than the forecast of 1.8 percent for the quarter. The slowdown in growth was mainly influenced by the decrease in private inventory investment and exports, the impact of which was partially offset by increases in government spending and household consumption expenditure.

Euro area annual growth slows

The euro area GDP increased by 0.2 percent in the second quarter of 2019, slightly lower than the 0.4 percent in the first quarter. The lower expansion in the second quarter of 2019 was on account of the weak manufacturing sector in the context of a less supportive global trade environment, including uncertainty surrounding Brexit.

¹⁰ Moody's warned that the South African government's funding injection for Eskom is credit negative and would be an additional drain on already limited fiscal resources, exacerbating South Africa's fiscal deficit to 5.7 percent of gross domestic product in 2019, up from the current projection of 5.2 percent.

¹¹ In the second quarter of 2019, the US increased tariffs on Chinese imports worth USD200 billion from 10 percent to 25 percent, after the two countries failed to reach a deal on trade. China retaliated by raising tariffs on a subset of US imports.

Growth declines in the UK

GDP in the UK contracted by 0.2 percent in the second quarter of 2019, following a 0.5 percent expansion in the first quarter. The decline in the second quarter of 2019, the worst performance since 2012, was driven by the fall in stockpiles and lower manufacturing output as production had been brought forward in anticipation of the March 29, 2019 Brexit date. Moreover, the shut downs by car manufacturers impacted negatively on growth.

Emerging markets' growth moderates

For emerging market economies, output growth softened, primarily due to heightening trade tensions, tightening financial conditions, rising US interest rates, capital outflows and volatile oil prices. In China, output grew by 6.2 percent in the second quarter of 2019, lower than the growth of 6.4 percent in the previous quarter and was the slowest quarterly growth in nearly three decades. The weaker performance was influenced by the prolonged heightened trade tensions with the US and weakening global demand.

In India, GDP grew by 5.8 percent year-on-year in the first quarter of 2019, the weakest growth in the past five years and was below the 6.6 percent in the fourth quarter of 2018 and the market expectation of 6.3 percent. Slower growth in the agriculture and manufacturing sectors contributed to the overall slowdown of the economy.

South African growth contracts

Regionally, output in South Africa contracted by 3.2 percent in the first quarter of 2019, following an increase of 1.4 percent in the previous quarter. It was the sharpest decline in the past ten years, mainly reflecting the negative effects of Eskom's power cuts on the manufacturing and mining sectors. Thus, the electricity, gas and water sector contracted by 6.9 percent, the largest decline since the third quarter of 2015, as electricity distribution reduced, with severe outages during the period.

Table 3.5: Growth Estimates and Projections

| | Estimate | | Projection | |
|--------------------|----------|------|------------|------|
| | 2017 | 2018 | 2019 | 2020 |
| Global | 3.8 | 3.6 | 3.2 | 3.5 |
| Advanced economies | 2.4 | 2.2 | 1.9 | 1.7 |
| USA | 2.2 | 2.9 | 2.6 | 1.9 |
| Euro area | 2.4 | 1.9 | 1.3 | 1.6 |
| UK | 1.8 | 1.4 | 1.3 | 1.4 |
| Japan | 1.9 | 0.8 | 0.9 | 0.4 |
| EMDEs | 4.8 | 4.5 | 4.1 | 4.7 |
| China | 6.8 | 6.6 | 6.2 | 6.0 |
| Brazil | 1.1 | 1.1 | 0.8 | 2.4 |
| India | 7.2 | 6.8 | 7.0 | 7.2 |
| Russia | 1.6 | 2.3 | 1.2 | 1.9 |
| South Africa | 1.4 | 0.8 | 0.7 | 1.1 |
| Botswana | 2.4 | 4.5 | 4.2 | 4.8 |

Source: IMF WEO Update July 2019 and Botswana 2019 Budget Speech

Note: EMDEs stands for emerging market and developing economies.

Global commodity prices

Diamond prices decrease

The global rough diamond price index decreased by 0.4 percent from 147.56 in the first quarter of 2019 to 146.99 in the second quarter due to higher than expected increase in polished diamond inventories which 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.

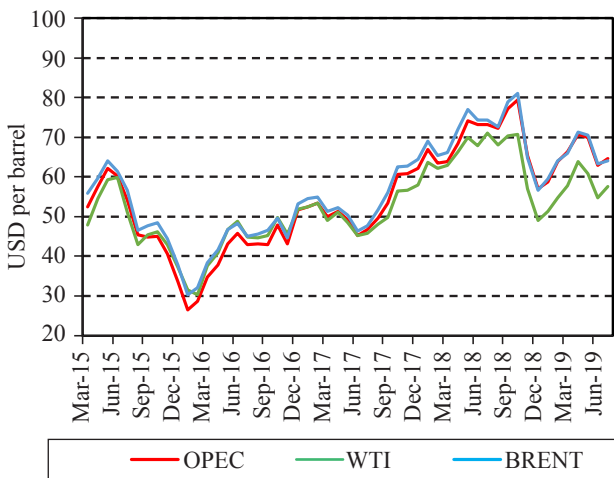
Similarly, the global polished diamond price index decreased by 0.62 percent from 215.8 in the first quarter of 2019 to 214.43 in the second quarter. This was due to the weaker demand for diamond jewelry and liquidity constraints forcing retailers to sell at a discount, in order to raise funds for bank loans repayments. In addition, the recent street protests in Hong Kong have dented sales of luxury goods, including diamond jewellery.

Oil prices increased in the second quarter of 2019

International oil prices (Brent crude and OPEC) increased to above USD65 per barrel in the second quarter of 2019, as oil producers complied with

production cuts agreed in December 2018¹², US oil inventories fell and geopolitical tensions persisted in the Middle-East. The OPEC reference crude oil basket price increased by 7.8 percent, from an average of USD62.98 in the first quarter of 2019 to USD67.89 per barrel in the second quarter (Chart 3.13). Similarly, the price of Brent crude oil increased by 8 percent from an average of USD63.27 per barrel to an average of USD68.33 per barrel, in the same period. The price of the West Texas Intermediate (WTI)¹³ also increased by 8.9 percent from an average of USD54.88 per barrel in the first quarter of 2019 to an average of USD59.80 per barrel in the second quarter.

Chart 3.13: Oil Prices (Monthly Averages)

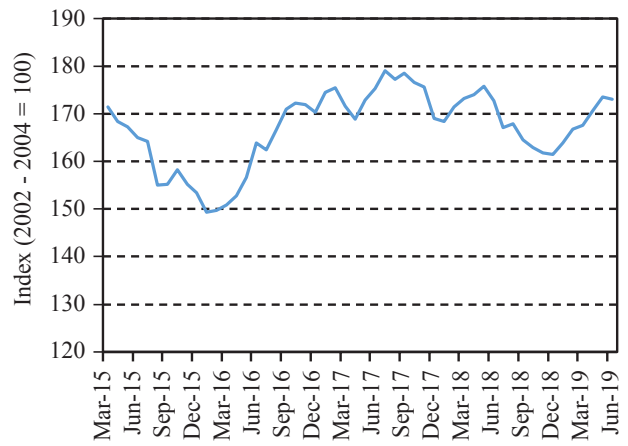


Source: OPEC and US Energy Information

Food prices decreased in the second quarter of 2019

According to the United Nations Food and Agriculture Organisation (FAO), the global food price index averaged 172.4 points in the second quarter of 2019, a 1 percent decrease from an average of 174.2 points in the corresponding period in 2018. The fall in prices was attributable to lower cereals and vegetable oil prices. The food price index averaged 170.9 points in July 2019, 1.1 percent below its level in June 2019, but 2.3 percent higher than in July 2018 (Chart 3.14).

Chart 3.14: Food Price Index

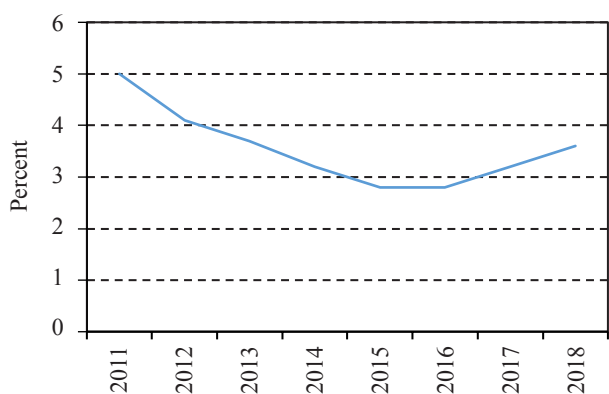


Source: Food and Agriculture Organisation

Global inflation eases in 2019

Global inflation is projected to ease from 3.6 percent in 2018 to 3 percent in 2019 (Chart 3.15). For advanced economies, inflation was unchanged at 1.8 percent in the first and second quarters of 2019 due to restrained growth in final demand. However, inflation increased from 2.7 percent to 3.2 percent in emerging market economies due to higher commodity prices in the same period. In South Africa, headline inflation averaged 4.5 percent in the second quarter of 2019, the same as in the corresponding quarter in 2018. Meanwhile, inflation was 4 percent in July 2019, remaining within the South African Reserve Bank (SARB)'s target range of 3 – 6 percent.

Chart 3.15: Global Inflation

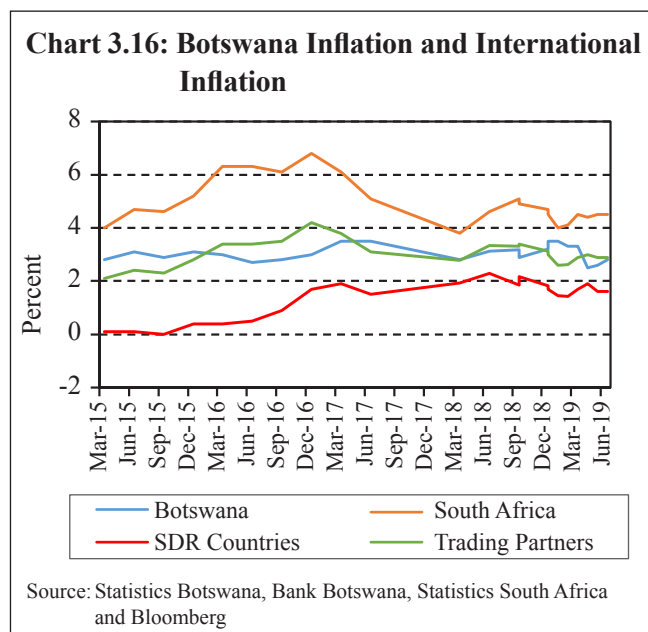


Source: Bloomberg

¹² At the July 1, 2019 meeting, OPEC and its allies extended the decision to reduce production by 1.2 million barrels a day by an additional nine months from the beginning of July 2019 to the end of March 2020.

¹³ WTI is a grade of crude oil used as a benchmark for oil pricing in the US.

Meanwhile, the average trade-weighted inflation for Botswana's trading partners was constant at 2.9 percent in May and June 2019 (Chart 3.16).



Mixed monetary policy developments

In the most recent policy decisions in advanced economies, the European Central Bank (ECB) and Bank of England (BoE) maintained their policy rates and confirmed that monetary policy would remain sufficiently accommodative (Table 3.6). In addition, to preserve favourable bank lending conditions and smooth transmission of monetary policy, the ECB will launch a new series of quarterly targeted longer-term refinancing operations¹⁴ starting in September 2019 until March 2021.

The Bank of Japan (BoJ) also maintained its ultra-accommodative monetary policy stance in July 2019, particularly asset purchases and low policy rate. Meanwhile, the range for the US Federal Funds Rate was reduced by 25 basis points to 2.0 - 2.25 percent in July 2019, in view of a global economic slowdown and muted inflation pressures. Moreover, the Federal Reserve (Fed) indicated that it would conclude the reduction of its aggregate securities holdings in August 2019, two months earlier than previously indicated.

In emerging market economies, the Reserve Bank of India reduced the policy rate by 35 basis points to 5.4 percent in August 2019, in response to slowing

domestic and external demand, as well as continued downside risks emanating from the global economic slowdown and trade tensions. Similarly, the Central Bank of Russia cut its key rate from 7.5 percent to 7.25 percent in July 2019, as inflation slowed and the economic outlook deteriorated. The SARB also reduced the repo rate by 25 basis points to 6.5 percent in July 2019, to stimulate the stagnating economy, following a contraction of output in the first quarter of 2019. Meanwhile, the Bank of Brazil cut its policy rate by 50 basis points to 6 percent in July 2019, in the context of weak economic activity, a decelerating global economy and low domestic inflation.

The People's Bank of China (PBoC) maintained the policy rate at 4.35 percent in April 2019, given the stable and resilient growth momentum. In addition, the PBoC injected funds to selected commercial banks through its targeted medium-term lending facility. In August 2019, the PBoC introduced a variable Loan Prime Rate (LPR) as the new benchmark for new bank loans in an attempt to reduce corporate borrowing costs. The LPR was set at 4.25 percent, replacing the fixed benchmark of 4.31 percent.

Table 3.6: Monetary Policy Decisions

| Central Bank | Latest Meeting | Current Policy Rate (Percent) | Change from Previous Meeting |
|--------------------|----------------|-------------------------------|------------------------------|
| Bank of Botswana | August 2019 | 4.75 | Decreased by 0.25% |
| SARB | July 2019 | 6.50 | Decreased by 0.25% |
| US Federal Reserve | July 2019 | 2.00 – 2.25 | Decreased by 0.25% |
| BoE | July 2019 | 0.75 | No change |
| ECB | July 2019 | 0.00 | No change |
| BoJ | July 2019 | -0.10 | No change |
| PBoC | April 2019 | 4.35 | No change |
| Brazil | July 2019 | 6.00 | Decreased by 0.50% |
| India | August 2019 | 5.40 | Decreased by 0.35% |
| Russia | July 2019 | 7.25 | Decreased by 0.25% |

¹⁴ These are the loans that the ECB provides to banks at low interest rates to ease credit conditions and stimulate bank lending.

4. THE ECONOMIC AND POLICY OUTLOOK

4.1 Global economic prospects

The global economic outlook has been revised downwards, on account of heightened trade tensions between the US and China, uncertainty surrounding Brexit, as well as weaker-than-expected economic expansion in the emerging market economies in the first half of 2019. Growth in advanced economies has been revised upwards on account of stronger-than-anticipated first quarter performance of the US economy, resulting from robust exports and inventory accumulation. Meanwhile, in South Africa, the growth outlook is projected to remain subdued due to a larger than anticipated negative impact of power supply shortages on the manufacturing and mining sectors. With regard to price developments, global inflation is forecast to decline from 3.6 percent in 2018 to 3 percent in 2019 and 2.9 percent in 2020, consistent with the projected decline in international oil prices.

Global economic outlook revised downwards

According to the July 2019 WEO Update, global output is forecast at 3.2 percent and 3.5 percent in 2019 and 2020, respectively, from an estimated expansion of 3.6 percent in 2018. The growth forecasts have been revised downwards by 0.1 percentage points for both 2019 and 2020, compared to the April 2019 WEO projections. The revisions take into account the heightened trade tensions between the US and China, uncertainty surrounding Brexit, as well as the weaker-than-expected economic expansion in the emerging market economies in the first half of 2019. The projected improvement in growth in 2020 is predicated on stabilisation of conditions in stressed emerging market and developing economies and progress towards resolving trade policy disputes.

For advanced economies, output growth is forecast to expand by 1.9 percent in 2019, before softening to 1.7 percent in 2020, compared to 2.2 percent in 2018. The 2019 projection is 0.1 percentage point higher than the April 2019 WEO projection, mainly reflecting the stronger-than-anticipated first quarter performance of the US economy, resulting from robust exports and inventory accumulation. Overall, risks to global output expansion are skewed to the downside. They include rising trade and technology tensions, tighter financial conditions and geopolitical risk.

UK economic prospects revised upward for 2019

The UK economy is expected to grow by 1.3 percent in 2019 (0.1 percentage point higher than in the April 2019 WEO) and by 1.4 percent in 2020, compared to 1.4 percent in 2018. The upward revision in 2019 relative to the April 2019 WEO reflects a higher output growth in the first quarter, boosted by inventory accumulation and stockpiling

ahead of the UK's original Brexit date. However, in the second quarter of 2019, there was a contraction in GDP due to a shut down by major car production companies as part of a Brexit contingency plan.

Positive economic outlook for US, albeit slower growth

For the US, output is forecast to grow by 2.6 percent in 2019 and 1.9 percent in 2020, from an expansion of 2.9 percent in 2018. The 2019 forecast is 0.3 percentage points higher than the April 2019 WEO projection, mainly reflecting the stronger-than-anticipated first quarter performance of the US economy, resulting from robust exports and inventory accumulation. However, the sluggish domestic demand and lower imports, arising from increased tariffs, are expected to slow down growth momentum in the second half of the year.

Growth for the euro area set to moderate

In the euro area, economic expansion is projected to ease from 1.6 percent in 2018 to 1.3 percent in 2019, before increasing to 1.6 percent in 2020 (0.1 percentage point higher than in the April 2019 WEO). The euro area growth is anticipated to improve in 2020 due to the expected recovery in external demand, and the dissipating impact of the temporary factors, such as the French street protests ("yellow vests").

Emerging markets GDP expansion projected to be lower

Growth in economic activity in emerging market and developing economies is projected at 4.1 percent and 4.7 percent for 2019 and 2020, respectively, from an estimated expansion of 4.5 percent in 2018. The forecasts have been revised downwards by 0.3 percentage points and 0.1 percentage point for 2019 and 2020, respectively, compared to the April 2019

WEO projections. The revisions are influenced by lower economic performance in all major regions, largely reflecting the effects of heightening trade tensions between the US and China.

The negative effects of escalating tariffs and weakening external demand in China have added pressure on the Chinese economy, hence a downward revision of 0.1 percentage point for both 2019 and 2020 (relative to April 2019 WEO) to a growth of 6.2 percent and 6 percent, respectively. However, it is expected that the policy stimulus will be supportive of economic activity. In India, the downward revision of 0.3 percentage points for both 2019 and 2020 reflects the weaker outlook for growth in domestic demand than previously envisaged.

Growth in the South African economy to remain subdued

Growth prospects in South Africa are expected to remain subdued, generally constrained by sluggish demand as a result of weaker business confidence. Output is expected to grow by 0.7 percent and 1.1 percent in 2019 and 2020, respectively, compared to 0.8 percent in 2018. Output growth for 2019 and 2020 have been revised downwards by 0.5 percentage points and 0.4 percentage points, respectively, reflecting the possibility of protracted electricity supply constraints. The mining and manufacturing industries are expected to be severely affected as the major consumers of electricity. Meanwhile, SARB revised the forecast for GDP growth for 2019 downwards to 0.6 percent from 1 percent, as a result of weak business and consumer confidence, while growth for 2020 was unchanged at 1.8 percent.

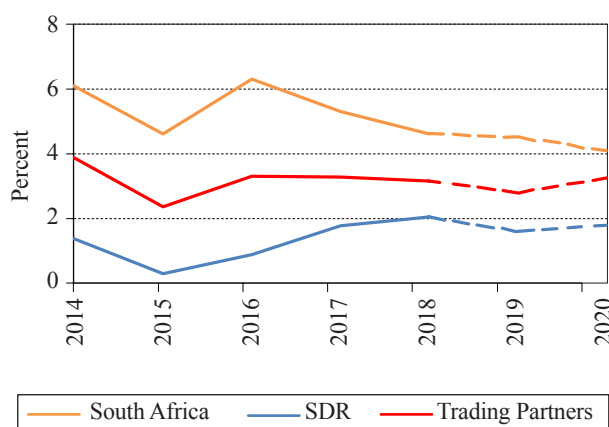
Global inflation to be moderate

Globally, the inflation outlook remains favourable in 2019, although there are indications of emerging disinflationary pressures emanating from slower global output growth. Global inflation is forecast to decline to 3 percent in 2019 and 2.9 percent in 2020, from 3.6 percent in 2018. In advanced economies, disinflationary pressures are expected to mount, mainly due to the anticipated lower inflation in the US and euro area. Similarly, for emerging market economies, inflation is expected to decrease in 2019, consistent with slowdown in growth of final demand. Meanwhile, South African inflation is forecast to average 4.5 percent in 2019, a downward revision of 0.2 percentage points from the previous forecast, mainly reflecting a stronger exchange rate,

as well as subdued domestic and global inflation pressures. Overall, inflation is anticipated to decrease but remain within the SARB's target range in the short to medium term (Chart 4.1).

Furthermore, at a global level, in the short to medium term, lower inflation and entrenched market expectations may increase debt servicing difficulties for borrowers, weigh down on corporate investment spending, and constrain the role of monetary policy in supporting growth in both advanced and emerging economies.

Chart 4.1: South Africa and SDR Headline Inflation



Source: SARB and Bloomberg

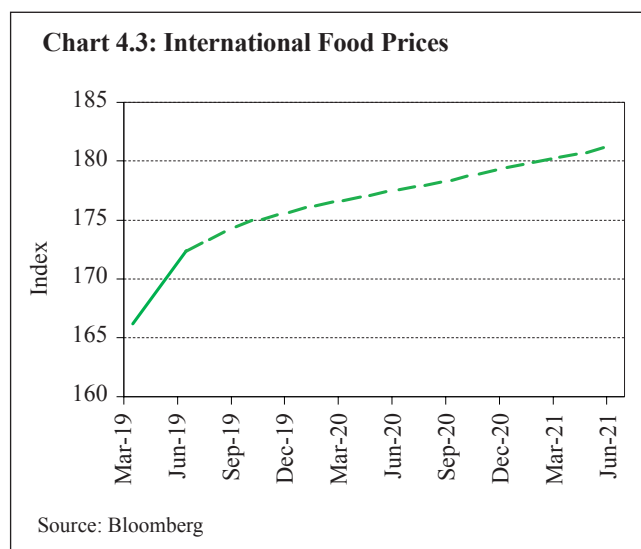
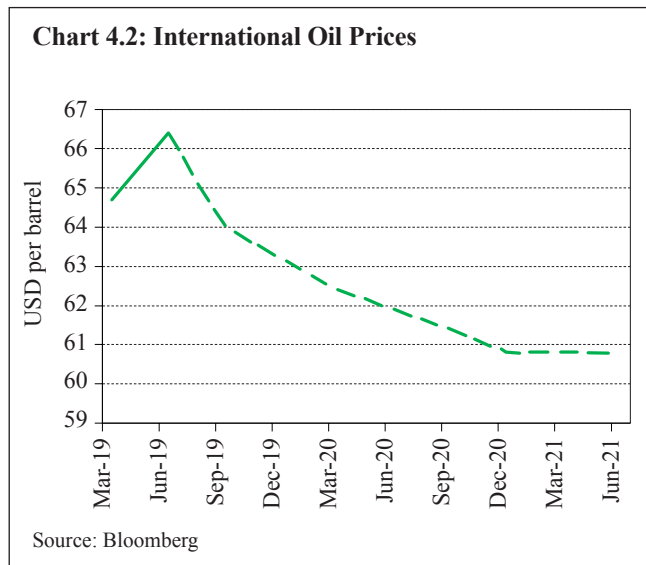
Diamond prices expected to fall

Global rough diamond prices are expected to trend downward in the second half of 2019, on account of the increase in polished diamond inventories due to global economic slowdown. Likewise, polished diamond prices as well as diamond jewellery prices are expected to fall in the second half of 2019 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 proliferation of synthetic diamonds and weak downstream sentiment related to macroeconomic and geopolitical factors.

International oil prices to decrease

International oil prices are projected to decrease in the second half of 2019 (Chart 4.2), influenced by the global economic slowdown, and the negative effects of the heightened trade tensions between the US and China. However, international oil prices are expected to remain above USD60 per barrel supported by the decline in US crude inventories and persistent tensions in the Middle-East. The extended agreement among oil producers to cut

production over nine months from the beginning of July 2019 to the end of March 2020 is expected to exert an upward pressure on international oil prices. Overall, developments in the international oil market imply modest downward pressure on domestic inflation.



Global food prices to increase

Global food prices are expected to trend upwards in 2019 and 2020 as prospects for global food production remain restrained (Chart 4.3). In Southern Africa, upward pressure on food prices is expected, due to the adverse impact on crop production caused by the El Nino weather condition anticipated in the latter part of 2019. The cyclones in Southern Africa that occurred in the first half of 2019 and expected to result in lower crop yields, as well as the spread of the African swine fever in China and some parts of Southeast Asia, Japan, Poland and Russia, which has affected production of pig meat, are anticipated to exert upward pressure on food prices. Overall, there is potential modest upward pressure from food prices on domestic inflation.

4.2 Outlook for domestic economic activity

The global economy is projected to slow down mainly due to heightened trade tensions between the US and China, which could negatively affect the diamond market. Meanwhile, the prevailing accommodative monetary conditions in the domestic economy and the expected growth in government expenditure should potentially sustain output growth in the non-mining sectors. In addition, improvements in water and electricity supply, as well as reforms to further improve the business environment, would generally be positive for economic activity. Hence, there are expectations of continued positive domestic output growth in the short to medium term, which is, however, projected to remain below its potential.

Improvement expected in domestic output

Projections from the 2019 Budget Speech indicate that domestic economic activity will expand by 4.2 percent and 4.8 percent in 2019 and 2020, respectively. The expected increase is mainly attributed to growth in mining output, which is projected to increase by 3.1 percent in 2019 and 2.5 percent in 2020. However, there is likelihood of downward revision of the projection for 2019, given that the projection took place before the heightened trade tensions between the US and China. The trade war is negatively affecting the diamond market.

The non-mining sectors are projected to grow by 4.4 percent and 5 percent in 2019 and 2020, respectively. Prospects for the non-mining sectors are supported by, among others, the prevailing accommodative monetary conditions in the

domestic economy and the expected growth in government expenditure in the 2019/20 fiscal year. Furthermore, improvements in electricity and water supply, as well as the reforms to further improve the business environment (see Box 3 for more details), would generally be positive for economic activity. In addition, prospective recovery of commodity prices and global market for exports should also support performance of the domestic economy. Even then, risks to global economic activity are skewed to the downside and could result in a fall in global demand and commodity prices, especially those of rough diamonds, and impact negatively on the domestic economic outlook. Meanwhile, the June 2019 Business Expectations Survey results suggest that firms are optimistic about business conditions. However, the level of optimism is expected to ease going forward, as firms anticipate higher input costs.

Box 3: Expected Drivers of Non-Mining Sectors

Trade, Hotels and Restaurants

- Continued implementation of events-based-tourism initiatives, such as the Toyota 1000 Desert Race, Khawa Sand Dune Challenge, Makgadikgadi Epic, and cultural festivals, promotion of dam tourism and government efforts to develop heritage sites. These developments create employment and enhance economic activity in the recreation and hotels sub-sectors, hence contributing to total output of the sector.
- Government initiatives aimed at facilitating the ease of doing business in Botswana. For example, implementation of Companies and Intellectual Property Authority (CIPA) online registration, the extended liquor trading hours and the reduction in the alcohol levy will address public concerns, such as loss of business and jobs and, thus, providing a boost to the economy.

Finance and Business Services

- Increase in financial and business services as a result of implementation of reforms on the ease of doing business in Botswana and also improved business confidence as reflected in the June 2019 Business Expectations Survey (BES). FinTech developments, such as electronic and cell phone banking services by some banks, will boost the financial services and business 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 will boost the construction sector and, ultimately, industries are expected to start operating in areas outside main cities and towns, which will stimulate economic growth.
- The implementation of the Cut 9 project in Jwaneng, Cut 3 project in Orapa and the Masama Coal Mine.
- Construction of transport-related infrastructure, such as the Boatle-Gaborone dual carriage road, Mohembo Bridge and Kazungula Bridge.
- The expected construction of three intersections along K T Motsete Drive at the Lobatse road, Kudumatse Drive and Willie Seboni/Mogoditshane road crossings.

Transport and Communications

- Government's efforts to develop Information and Communications Technology through broadening network coverage, such as the Government data network upgrading.

Manufacturing

- Local manufacturers to benefit from the Economic Diversification Drive (EDD) initiative that requires Government departments to procure products and services from local manufacturers. The EDD initiative has recently been under review with a view of making it more relevant and impactful.

- Reform of Botswana Meat Commission (BMC) and liberalisation of the beef export market. Furthermore, Government is implementing the Beef Productivity Training Programme through development cooperation with the Government of New Zealand to improve productivity of the beef sub-sector through training of farmers, herdsman and extension staff.
- Expansion of dairy sub-sector by improving strategic dairy farms and leasing out unutilised farms to the private sector. Progress so far includes developments in the Sunnyside Dairy Farm which continues to increase its dairy herd and secure additional land for fodder production to increase milk output.

Water and Electricity

- Operation of the Morupule A power plant, which has been under refurbishment.
- Establishment of the Botswana Energy Regulatory Authority (BERA) to promote sustainable and secure energy supply across the country. BERA continues to issue trading licences for petrol filling stations, petroleum wholesale and other industrial licences related to petroleum products, as well as standby generator provisional licences.
- Continued Government efforts to increase water supply across the country, such as through the Emergency Water Security and Efficiency Project and the Lesotho-Botswana Water Transfer (LBWT) Project. The LBWT project's feasibility study commenced in August 2018 and is set for completion in June 2020.

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.
- The Local Enterprise Authority (LEA), which aims to promote entrepreneurship and SMME development, is also expected to further enhance the SMME participation in the economy, hence improve citizen economic empowerment.
- Makoro Project, along the A1 road, which is being undertaken in partnership with Debswana, Morupule Coal Mine and Botswana Telecommunications Corporation. The aim of the Project is to support and encourage local SMMEs to improve their doing business environment by building temporary structures for the Vendors at Makoro Veterinary Gate. This will enhance the business environment and attract both local and international travellers to stop and refresh at this location, during their travel.

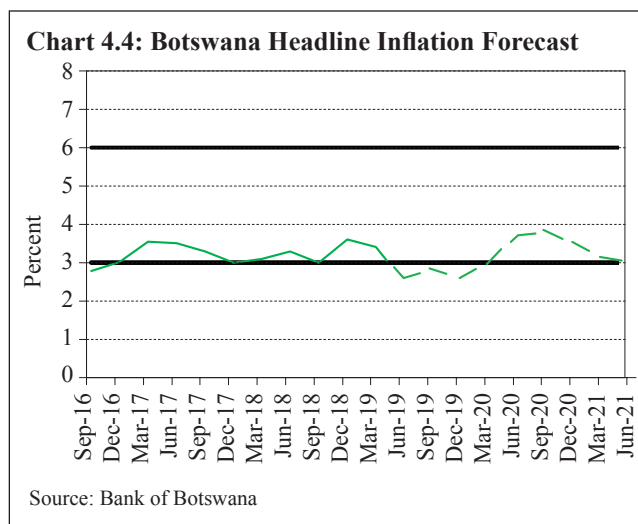
4.3 Domestic inflation outlook

Inflation is forecast to remain slightly below the lower bound of the Bank's 3 - 6 percent objective range for the remainder of 2019. Nonetheless, inflation is expected to revert to within the objective range in the first quarter of 2020. Compared to the June 2019 inflation projection, the current inflation forecast is broadly unchanged, as most of the assumptions used for both forecasts do not differ substantially. Upside risks to the inflation outlook relate to any substantial upward adjustment in administered prices and government levies and/or taxes, and any increase in international oil and food prices beyond current forecasts. These risks are moderated by prospects of weak global economic activity and continuance of modest domestic economic growth and government spending.

Inflation projected to be within the objective range in the medium term

Headline inflation is projected to remain slightly below the lower bound of the Bank's medium-term objective range in the second half of 2019, but to return to the objective range in the first quarter of 2020 (Chart 4.4). The current inflation forecast is broadly unchanged from the June 2019 projection, since the underlying assumptions also remain broadly unchanged.

Following the significant decline in inflation in the second quarter of 2019, due to base effects associated with the increase in public transport fares, electricity tariffs and fuel prices in the second quarter of 2018, it is anticipated that inflation will remain slightly below the lower bound of the Bank's 3 - 6 percent objective range in the near term. Moreover, the base effects associated with the increase in fuel prices¹⁵ in the fourth quarter of 2018 are expected to further suppress inflation in the last quarter of 2019. However, inflation is expected to revert to within the objective range in the first quarter of 2020. The projection takes into account the possibility of an upward adjustment in administered prices, as well as the already announced increase in public service salaries in the 2020/21 financial year.



Meanwhile, according to the BES of June 2019, the business community expects inflation to be within the objective range in both 2019 and 2020.

Core inflation to increase in the short term

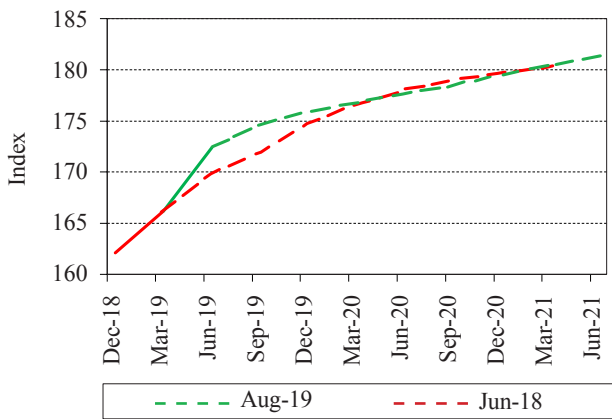
Inflation, excluding food and fuel prices, is forecast to rise in the short term, mainly driven by the likely upward adjustment in administered prices. Moreover, the increase in public service salaries is expected to exert an upward but minimal pressure on the core inflation. However, core inflation is expected to be stable in the medium term.

International food prices to increase

Compared to the June 2019 forecast, international food prices have been revised slightly upwards in the near term and remain relatively unchanged for the entire forecast period (Chart 4.5). The slight revision in food prices in the near term mainly reflects adverse weather conditions and the spread of the African swine fever in China and in some parts of Southeast Asia, Japan, Poland and Russia, which has affected production of pig meat.

¹⁵ The increase fuel prices added approximately 0.9 percentage points to headline inflation in the fourth quarter of 2018.

Chart 4.5: International Food Prices

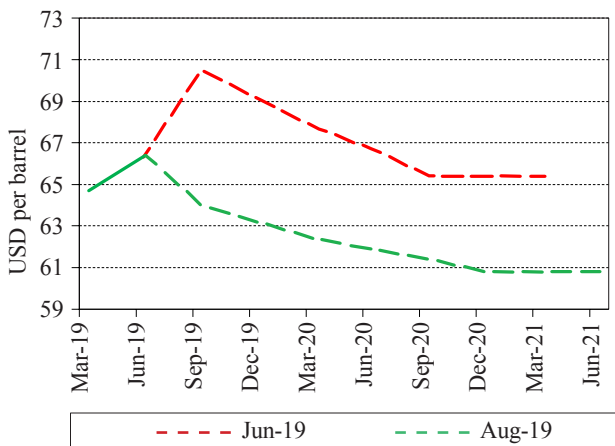


Source: Bloomberg

International oil prices revised downwards

Relative to the June 2019 projection, international oil prices have been revised downwards (Chart 4.6), mainly influenced by the global economic slowdown, as well as heightened trade tensions between the US and China.

Chart 4.6: International Oil Prices



Source: Bloomberg

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

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 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 against any individual currency.

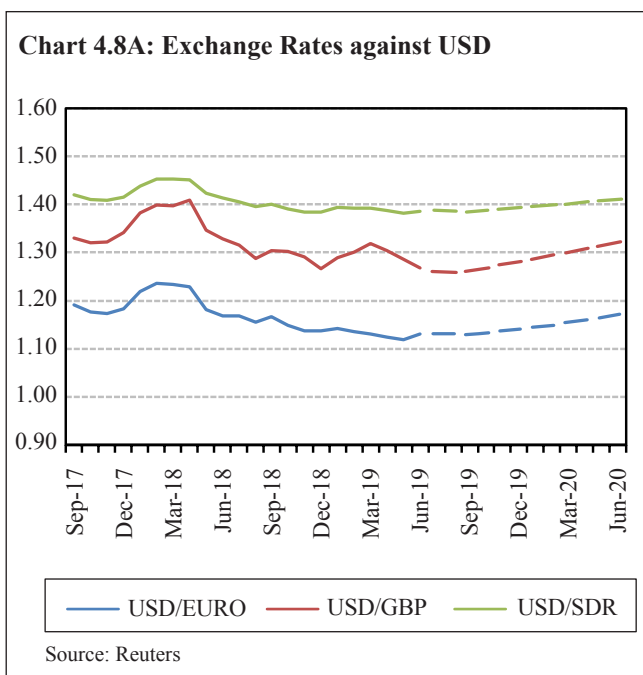
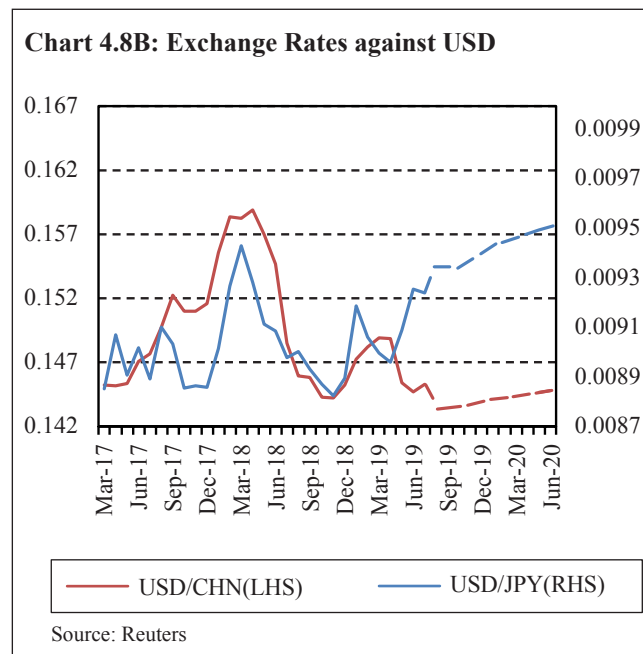
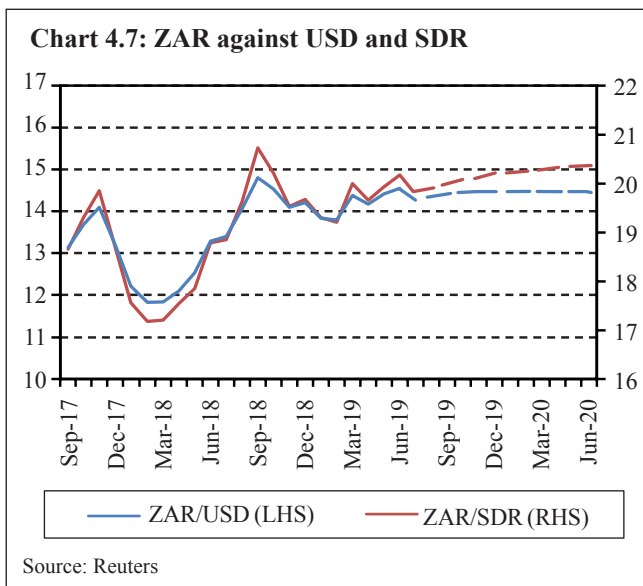
The South African rand is expected to depreciate marginally against major currencies in the next four quarters (Chart 4.7), due to the country's weak economic fundamentals and the South African fiscal budget that could be worsened by the approval of additional R59 billion in support for Eskom for the next two financial years. This is in addition to the R23 billion already approved for each of the 2019/20 and 2020/21 financial years. Moody's¹⁶ warned that government's additional support to ease Eskom's financial pressures would exacerbate public debt, thus credit negative for South Africa.

The prospects of monetary policy easing in developed economies should benefit the rand against the US dollar, should South Africa's real interest rates remain more attractive than its emerging markets peers. However, the full benefit of lower global rates will likely be diminished by trade tensions, slowing global growth, developments of Brexit, contagion effect from the geopolitical tensions between the US and Iran and unfavourable changes in investor sentiment towards emerging markets assets.

The South African rand is, therefore, expected to depreciate marginally against major international currencies in the next four quarters. Consequently, the Pula is expected to appreciate against the rand in the same period.

The US dollar is expected to depreciate marginally against major international currencies in the next four quarters (Chart 4.8A and Chart 4.8B), amid expectations of a slowdown in the US economy, occasioned by the effects of the trade war between the US and China and heightened pressure on the

¹⁶ Moody's is the last major rating agency to still have South Africa rated as an 'investment grade'. However, the rating agency warned that South Africa's sovereign rating could be cut if the government does not get its spending and fiscal deficit under control.



is expected to increase interest rates gradually if Britain manages to exit the European Union with a transition deal to absorb the economic shock. Meanwhile, the euro is expected to appreciate against the US dollar as markets are pricing-in a more aggressive rate cut by the Federal Reserve in the coming months, than the ECB.

The Japanese yen is expected to appreciate against the US dollar owing to its safe haven status during times of global economic distress. The currency has been used by investors to hedge against risks in emerging markets assets and the tension between the US and China.

The Chinese renminbi is expected to depreciate marginally against the US dollar in the next quarter (Chart 4.8B) on the back of the resurgence of risk-off sentiments, after the US President's announcement of an extra 10 percent tariff on Chinese goods effective September 1, 2019. Following the US announcement, the People's Bank of China started allowing the renminbi to depreciate against the dollar as a counter to the tariff imposition, a move which might carry on into the foreseeable future to neutralise the effects of the tariffs. However, the renminbi is expected to recover against the US dollar as markets price-in a more aggressive rate cut by the Federal Reserve.

Federal Reserve to reduce interest rates further¹⁷ in order to ease financial conditions and encourage business, following the latest escalation¹⁸ of the US-China trade war which is expected to slow the US economy even further.

The British pound is expected to appreciate against the US dollar on the back of relatively strong initial conditions (tight labour market and inflation at target) and prospects of greater clarity emerging in the near term regarding the UK and the European Union's future relationship. Furthermore, the BoE

¹⁷ The Federal Reserve cut its benchmark interest rate as an insurance policy against the effects of trade tensions, by a quarter of a percentage point on July 31, 2019, to a range of 2 - 2.25 percent, the first reduction in borrowing costs since the financial crisis a decade ago.

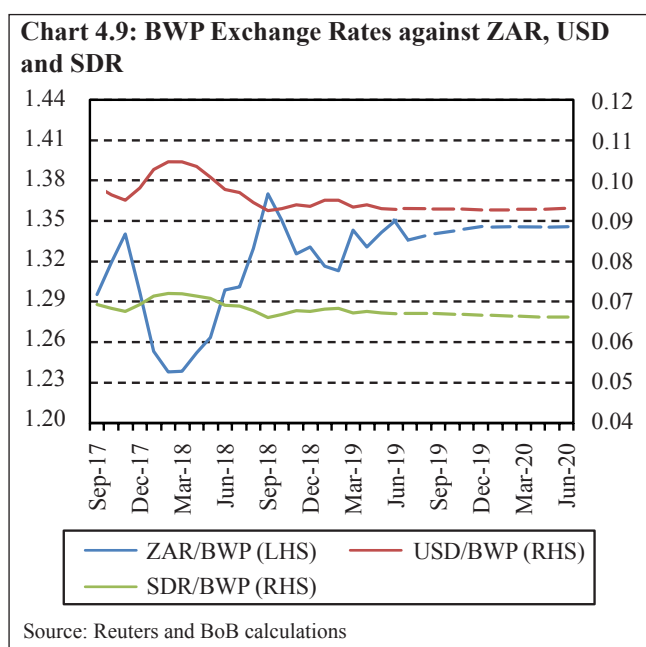
¹⁸ The extra 10 percent tariffs on an additional USD300 billion Chinese imports that the US plans to implement from September 1, 2019 means virtually all of the USD550 billion of goods that America buys from China every year have been targeted.

Overall, forecast movements of the SDR constituent currencies would result in the appreciation of the SDR against the US dollar (Chart 4.8A).

The anticipated depreciation of the rand against major international 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 will continue to exert downward pressure on domestic inflation going forward.

Risks broadly unchanged

Risks to the inflation outlook identified at the June 2019 MPC meeting remain relevant. On the domestic front, upside risks relate to any considerable upward adjustment in administered prices (in



particular, Botswana Housing Corporation rentals) and government levies and/or taxes. Externally, any increase in international food and oil prices beyond current forecasts may exert upward pressure on domestic inflation. However, there are downside risks associated with prospects of weak global economic activity (exacerbated by the deepening trade war between the US and China), the tendency of technological progress to lower costs and prices and the potential fall in international commodity prices. Domestically, the continuance of modest economic growth and government spending could lead to subdued inflation.

5. AUGUST 2019 MONETARY POLICY COMMITTEE DECISION

At the meeting held on August 29, 2019, the MPC of the Bank of Botswana decided to reduce the Bank Rate by 25 basis points from 5 percent to 4.75 percent. Inflation increased from 2.8 percent in June 2019 to 2.9 percent in July, and was below but closer to the lower bound of the Bank's objective range of 3 – 6 percent. Nonetheless, the outlook for price stability remains positive as inflation is forecast to revert to within the Bank's 3 – 6 percent objective range in the first quarter of 2020.

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 and government levies and/or taxes, beyond current forecasts. However, modest growth in global economic activity, technological progress and productivity improvement present downside risks to the outlook.

Real GDP grew by 4.4 percent in the twelve months to March 2019, compared to a lower expansion of 3.8 percent in the corresponding period in 2018. This was mainly attributable to the continued good performance in non-mining sectors and recovery in mining output. Mining output expanded by 5.3 percent in the year to March 2019, compared to a contraction of 0.3 percent in the corresponding period in 2018. Non-mining GDP grew by 4.3 percent in the year to March 2019, the same growth in the corresponding period in the previous year. The significant influences on domestic economic performance include conducive financing conditions as indicated by accommodative monetary policy and sound financial environment that facilitate policy transmission, intermediation and risk mitigation. Moreover, it is anticipated that the increase in government spending, as well as implementation of initiatives, such as the doing business reforms, should also be supportive of economic activity. Overall, the economy is projected to operate close to, but below full capacity in the short to medium term, thus posing no upside risk to the inflation outlook.

Global output growth is expected to ease to 3.2 percent in 2019, from an estimated expansion of 3.6 percent in 2018. The expected moderation in global growth is due to various factors, including inter-alia: heightened trade tension between the US and China, which has possibility to hamper confidence, investment and growth; uncertainty surrounding Brexit; as well as weaker-than-expected activity in emerging market and developing economies.

Regionally, the South African Reserve Bank revised its forecasts for GDP growth for 2019 downwards to 0.6 percent from 1 percent, as a result of weak business and consumer confidence.

The current state of the economy and the outlook for both domestic and external economic activity provide scope for easing monetary policy to support economic activity. Accordingly, the MPC decided to reduce the Bank Rate by 25 basis points to 4.75 percent. However, with inflation low and stable and inflation expectations well anchored, improving total factor productivity remains key in promoting sustainable and inclusive economic growth.

Commercial banks are required to make the necessary interest rate adjustments with immediate effect to reflect this policy decision.

The remaining MPC meetings for 2019 are scheduled for October 31, 2019 and December 5, 2019.

