MONETARY POLICY REPORT

OCTOBER 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 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 formulation and implementation of monetary policy. It provides a comprehensive, forward-looking framework for policy formulation by the Monetary Policy Committee (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 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 to, and engaging in Repo/Reverse Repo transactions with, commercial banks, as well as adjustment of 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 activities; and Director of the Banking Supervision Department. The MPC holds six 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 preannouncement of the 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 key considerations and drivers for the decisions. 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 launch 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 the restrained increase in personal incomes and modest increase in foreign prices. Hence, the Bank Rate was maintained at 5 percent at the October 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. However, restrained growth in global economic activity, technological progress and productivity improvement, along with modest wage growth, present downside risks to the inflation outlook.

The Bank's 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 percent in the third quarter of 2018, a decline from an average of 3.3 percent in the third quarter of 2017, largely reflecting the reduction in food inflation. Headline inflation is expected to remain within the 3 – 6 percent objective range in the short to medium term.

Gross Domestic Product (GDP) grew by 4.4 percent in the twelve months to June 2018, higher than the 3.2 percent growth in the corresponding period ending in June 2017. In the context of the anticipated growth 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. 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, and 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 the achievement of a higher level of economic activity.

Annual growth in commercial bank credit accelerated to 7.6 percent at the end of the second quarter of 2018 from 4.1 percent in the corresponding period in 2017, reflecting, in part, increased utilisation of existing credit facilities by some of the diamond cutting and polishing companies. The latest data indicate that growth in total credit in the twelve months period to August 2018 decelerated to 7 percent from 7.3 percent in July.

At the end of August 2018, foreign exchange reserves amounted to P77.3 billion, an increase of 0.9 percent from P76.6 billion in August 2017, and were equivalent to 19 months of import cover of goods and services. The increase in the foreign exchange reserves is due to net foreign currency revaluation gains, mainly arising from the depreciation of the Pula against the currencies in which the reserves are held. The current account continues to record a surplus, mainly driven by Southern African Customs Union (SACU) receipts. The surplus in the second quarter of 2018 was higher compared to that recorded in the corresponding quarter in 2017 due to the increase in diamond exports.

The nominal effective exchange rate (NEER) of the Pula depreciated by 0.2 percent in the twelve months to September 2018, consistent with the transition from a 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 September 2018. The depreciation of the Pula against SDR currencies (except the Chinese renminbi) reflects the performance of the rand against those currencies. Meanwhile, in the year to September 2018, the real effective exchange rate (REER) depreciated by 0.6 percent, largely reflecting the negative inflation differential between Botswana and the trading partner countries, and a virtually stable NEER.

The global economy continued to expand in the second quarter of 2018, providing a favourable backdrop for domestic economic activity. Economic performance strengthened in the United States (US), mainly driven by improved domestic demand and higher consumer and business confidence. In the euro zone, economic growth slowed in the second quarter of 2018, due to lower consumer spending owing to higher inflation and sluggish wage growth, as well as lower investor confidence caused by trade tensions. 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. Thus, for commodity exporters, growth was mainly driven by the increase in commodity prices. Meanwhile, South Africa went into a technical recession, as GDP contracted by 0.7 percent in the second quarter of 2018, following a 2.6 percent contraction in the first quarter. The contraction in GDP was attributable to poor performance in the agriculture, transport and trade sectors, which recorded negative growth.

The global rough diamond price index decreased in the third quarter of 2018, reflecting trade tensions between the US and China. The polished diamond price index also decreased in the same period, due to lower world economic prospects and negative consumer sentiment. International oil prices remained above USD70 per barrel in the third quarter of 2018. The Organisation of the Petroleum Exporting Countries (OPEC), and its non-OPEC partners, have agreed to increase oil production from July 2018 in order to moderate rising oil prices influenced by US sanctions against Iran and increased demand. Meanwhile, the United Nation's Food and Agriculture Organisation (FAO) food price index decreased in the third quarter of 2018, as international prices of all food groups, except sugar, fell.

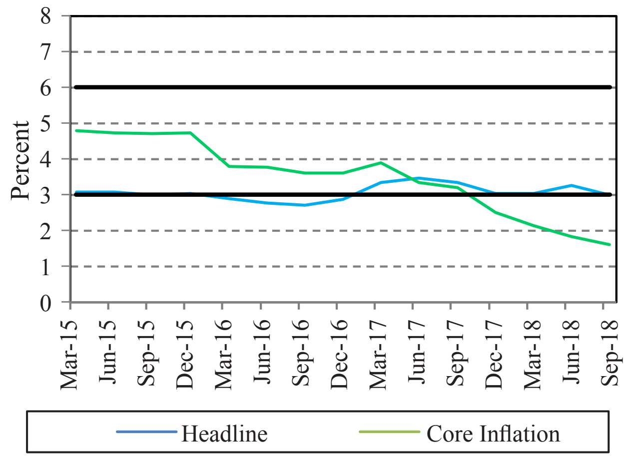
3. RECENT ECONOMIC DEVELOPMENTS

3.1 Recent inflation environment

Headline inflation decreases in the third quarter of 2018

Headline inflation averaged 3 percent in the third quarter of 2018, lower than the 3.3 percent in the third quarter of 2017 (Chart 3.1), mainly reflecting lower food inflation. Headline inflation was 2.9 percent in September 2018, thus breaching the lower bound of the objective range, for the second time in 2018 (Table 3.1). Inflation remains low and stable, reflecting, in part, modest domestic demand, the relative strength of the Pula against the rand and related slower increase in prices of imported goods. However, the current poor harvest in the region, due to drought conditions, is expected to trigger an acceleration in food price inflation. Moreover, the increase in international oil prices in the third quarter of 2018 is also expected to exert modest upward pressure on domestic inflation.

Chart 3.1: Botswana Headline and Core Inflation

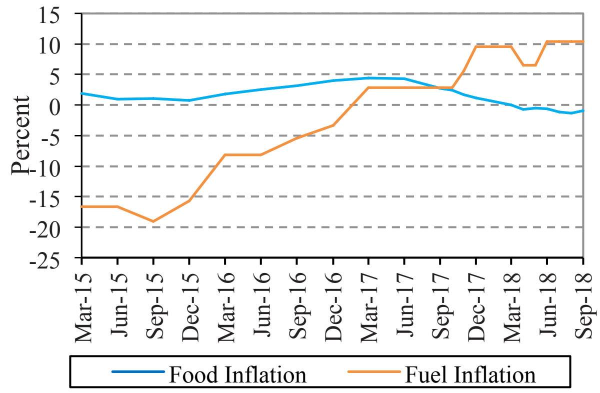


Source: Statistics Botswana
Note: Core Inflation is headline inflation excluding administered prices

Core inflation measures diverge

Core inflation, which excludes administered prices (CPIXA), averaged 1.6 percent in the third quarter of 2018, a decrease from 3.2 percent in the third quarter of 2017, while the trimmed mean inflation (CPITM) increased to 3 percent from 2.8 percent in the same period. Inflation excluding food and fuel prices (CPIXFF) averaged 3.1 percent in the third quarter of 2018, lower than the 3.3 percent in the corresponding quarter in 2017 (Table 3.1). In September 2018, CPIXA and CPITM were 1.6 percent and 2.9 percent, respectively, while CPIXFF was 2.9 percent.

Chart 3.2: Food and Fuel Inflation (Monthly)



Source: Statistics Botswana, Bank of Botswana

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

Category of commodities	Basket Weights	Sep 2018	Q3 2018	Q3 2017
Miscellaneous goods and services	10.6	7.4	7.5	2.7
Transport	20.7	7.3	7.5	1.6
Education	3.3	5.4	5.4	4.2
Restaurants and hotels	2.8	3.4	3.5	3.9
Housing, water, electricity, gas and other fuels	14.9	3.4	3.5	6.1
Furnishing, household equipment and routine maintenance	6.4	2.2	2.0	3.3
Recreation and culture	2.9	1.9	1.9	2.3
Clothing and footwear	6.3	1.7	1.8	2.9
Health	3.6	1.0	0.9	2.0
Alcoholic beverages and tobacco	7.8	0.8	0.8	4.9
Food and non-alcoholic beverages	16.5	-0.9	-1.1	3.6
Communication	4.3	-9.1	-8.5	0.6
Annual Inflation (All items)	**100.0**	**2.9**	**3.0**	**3.3**
CPITM		2.9	3.0	2.8
CPIXA		1.6	1.6	3.2
CPIXFF		2.9	3.1	3.3

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

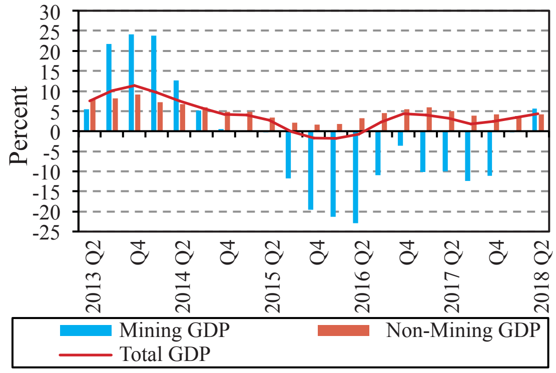
Core Inflation Measures	Description	Advantages	Disadvantages
Inflation by excluding food and fuel (CPIXFF)	Excludes volatile food and fuel items from the CPI basket Widely used across central banks	Easy to compute and communicate	May exclude items that contain important signals about underlying inflation
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 4.4 percent in the twelve months to June 2018, a faster rate than the 3.2 percent expansion in the year to June 2017 (Table 3.3).[1] The larger increase was mainly due to the recovery in the mining sector, which grew by 5.6 percent compared to a contraction of 10 percent in the previous year. The recovery in the mining sector was mainly attributable to the 11.7 percent increase in diamond mining output (mainly by Debswana), compared to an 8 percent expansion in the previous year. The resumption of production of soda ash at the Botash Mine, following refurbishment shutdown in the second quarter of 2017, led to an increase in soda ash output of 10.8 percent compared to a contraction of 4.6 percent in the corresponding period ending in June 2017. Other mining sub-sectors, except copper, also registered positive growth in the period under review. Moreover, a 4.3 percent growth in non-mining GDP in the twelve months to June 2018 also contributed to the increase in overall growth although lower than the 5 percent in the corresponding period ending in June 2017. The lower rate of growth of non-mining GDP was attributable to the lower diamonds sales by De Beers Global Sightholder Sales (DBGSS), which had a negative impact on the performance of the trade, hotels and restaurants sector. Meanwhile, output in the second quarter of 2018 was 2.4 percent larger, compared to the P23.5 billion in the first quarter of 2018.

Chart 3.3: GDP Growth Rates



Source: Statistics Botswana

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

[1] Growth rates are reported on a rolling 12-month basis. For example, for 2018Q2, the annual growth is calculated from the level of GDP estimated for the 12 months to June 2018 compared to the level of output for the corresponding 12-month period ending in June 2017.

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

	2017Q2	2018Q1	2018Q2
Total GDP	3.2	3.3	4.4
Mining	-10.0	-0.3	5.6
Non-Mining	5.0	3.8	4.3
Agriculture	2.4	2.2	2.7
Manufacturing	1.4	2.9	3.8
Water and Electricity	13.9	*6.7*(7.5)	2.0
Construction	4.0	3.4	3.6
Trade, Hotels and Restaurants	12.3	2.5	4.1
Transport and Communications	6.0	5.2	5.2
Financial and Business Services	4.0	5.1	5.2
General Government	2.3	2.6	2.9
Social and Personal Services	3.0	3.1	3.2
Government Final Consumption	2.5	3.8	3.5
Household Final Consumption	3.4	*5.5*(6.6)	6.6
Gross Fixed Capital Formation	-4.2	*-7.7*(-7.0)	-0.9
Exports	14.9	*-18.1*(-18.5)	-15.9
Imports	-18.9	*-16.4*(-16.8)	-5.6

Note: The figures in italics are revisions of the figures in brackets previously reported in the Q1 estimates.
Source: Statistics Botswana and Bank of Botswana calculations

Diamond production decreased in the third quarter of 2018

Debswana produced 5.7 million carats of diamonds in the third quarter of 2018, a decrease of 5.9 percent from the corresponding period in 2017, mainly due to the planned processing of lower grade material at Jwaneng Mine. Hence, production at Jwaneng Mine decreased by 9.6 percent in the third quarter of 2018, while production at the Orapa Mine was almost unchanged in the same period. Orapa output includes production from Orapa, Damtshaa and Letlhakane mines. Meanwhile, output from Letlhakane Mine is from the Tailings Resource Treatment Plant, which is envisaged to produce up to 800 000 carats a year and extend the life of the Letlhakane Mine by at least twenty years. Overall, Debswana still anticipates production of 23.8 million carats in 2018, which would be 4.8 percent higher than the 22.7 million carats in 2017.

Production by Lucara Diamond Corporation (Karowe Mine) increased by 41.4 percent to 81 507 carats in the second quarter of 2018, from 57 624 carats in the corresponding period 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. Meanwhile, Karowe Mine anticipates producing between 270 000 and 290 000 carats of diamonds in 2018.

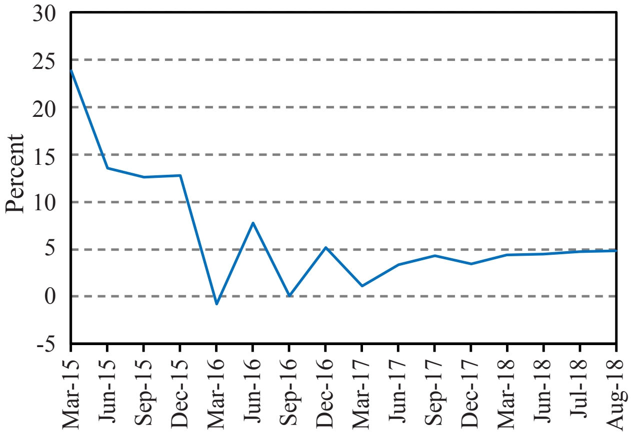
3.3 Monetary developments

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), driven by an increase in loans and advances.

In the one-year period ending in August 2018, growth in commercial banks' assets remained unchanged at 4.8 percent from July 2018.

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



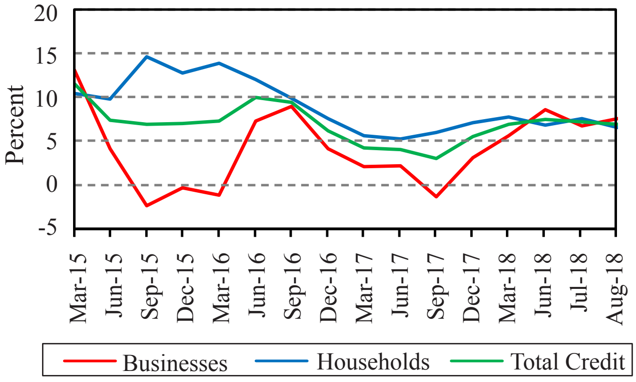
Source: Commercial Banks

Credit growth accelerates in the second quarter of 2018

Year-on-year increase 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 faster growth in lending to both the business sector (partly reflecting the increased utilisation of existing credit facilities by some diamond cutting and polishing companies) and households (personal loans in particular).

Beyond June 2018, growth in commercial bank credit decelerated to 7 percent in August 2018 as the annual increase in lending to households fell from 6.9 percent in June to 6.6 percent in August 2018. Growth in borrowing by businesses also decreased from 8.6 percent to 7.6 percent in the same period.

Chart 3.5: Year-on-Year Growth in Commercial Bank Credit

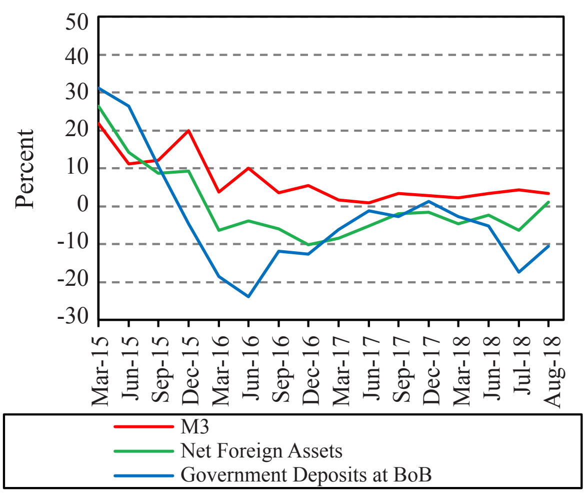


Source: Commercial Banks

Money supply accelerates in the second quarter of 2018

Annual rate of 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 decline in government deposits at the Bank of Botswana (thus, spending by the Government), which was partly offset by a decline in net foreign assets. Annual growth of 3.4 percent was maintained in the twelve months to August 2018.

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

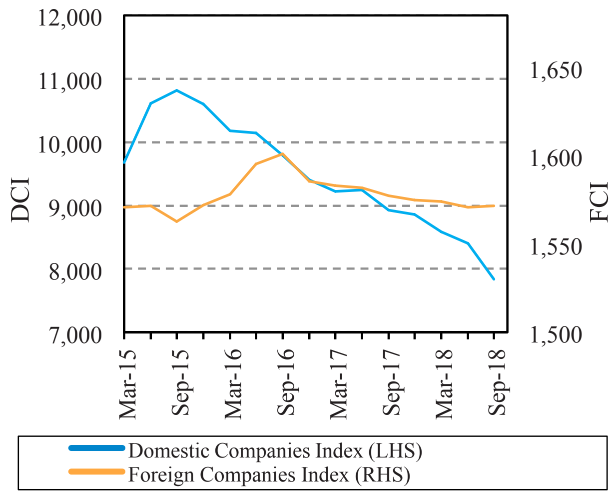


Source: Commercial Banks, Bank of Botswana

Stock market index declines
The Domestic Companies Index (DCI) declined by 12.2 percent in the twelve months to September 2018, following an 8.8 percent fall in the year to September 2017. The decline was attributed to year-on-year decrease in price per share for Choppies (-83.5 percent), Botswana Telecommunications Corporation Limited (-41.9 percent), Olympia (-40 percent), Stanchart (-22.2 percent), Letlole (-21.9 percent) and Coreshares (-19.5 percent). The decline in the Choppies share price was due to the delay in publication of their audited financial statements, among other concerns.

The Foreign Companies Index (FCI) declined by 0.4 percent in the twelve months to September 2018, compared to a decline of 1.5 percent in the corresponding period ending in September 2017. This was largely attributed to the year-on-year decrease in price per share of Lucara (-10.2 percent) and Botswana Diamonds plc (-27.3 percent).

Chart 3.7: Stock Market Indices



Source: Botswana Stock Exchange

Bank of Botswana Certificates Yields increase
The 14-day BoBC stop-out yield increased to an average of 1.53 percent in the third quarter of 2018 from 1.46 percent in the corresponding period in 2017, while the 3-month BoBC yield also increased to an average of 1.55 percent from 1.47 percent in the same review period. Meanwhile, the real rate of interest for the 14-day BoBC increased from -1.82 percent in the third quarter of 2017 to -1.43 percent in the third quarter of 2018, reflecting the decrease in the inflation rate. Similarly, the real interest rate for the 3-month BoBC increased from -1.8 percent to -1.41 percent in the same period.

3.4 Property market

Property market remains weak in the first quarter of 2018[2]
The market for the lower and medium cost residential property is reported to be relatively strong compared to the weaker higher-end segment. Residential property sales in areas adjacent to Gaborone, such as Mogoditshane, Gabane, Oodi and Modipane, were 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 due to weaker demand.

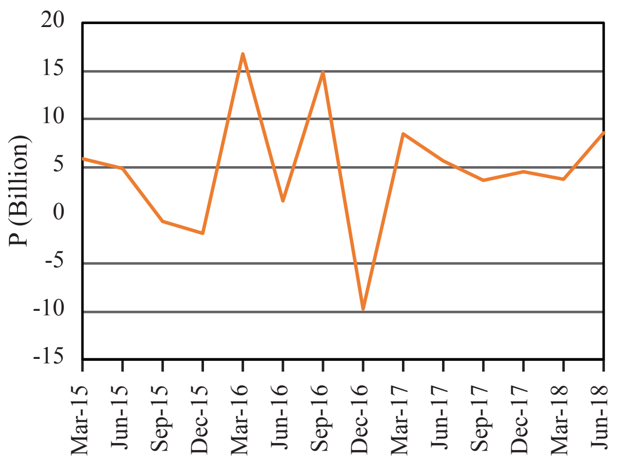
The market for office space remains weak due to increasing supply from completed construction developments at the Central Business District (CBD) and slow take-up of office space. The supply for office space is likely to increase further going forward, given the ongoing construction projects at the CBD. Meanwhile, the demand for retail space remains fair across all market segments, with proposed major shopping centres in the CBD, Gaborone Block 10 and Mogoditshane. In addition, other centres with good demand for retail space are Palapye, 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 further.

3.5 Balance of payments

Current account in surplus in the second quarter of 2018
A current account surplus of P8.5 billion was recorded in the second quarter of 2018, larger than a surplus of P5.6 billion in the second quarter of the previous year (Chart 3.8). The surplus was mainly attributable to a 23.2 percent increase in diamond exports. This was due to favourable trading conditions in the diamond market, especially following high demand for diamonds at the Las Vegas Trade Show during the second quarter of 2018. Diamonds accounted for 91 percent of total exports in the second quarter of 2018 compared to 88 percent in the corresponding period a year ago.

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

Chart 3.8: Quartely Current Account Balance



Source: Bank of Botswana

Moreover, the current account continues to benefit from the Southern African Customs Union (SACU) receipts. However, the receipts decreased by 13.3 percent from P4.5 billion in the second quarter of 2017 to P3.9 billion in the second quarter of 2018 due to adjustments for overpayments for the 2017/18 financial year.

Outflow from the financial account in the second quarter of 2018

The overall financial account had an estimated net outflow of P2.2 billion during the second quarter of 2018 compared to a net inflow of P3.8 billion in the second quarter of 2017. The net outflow is attributable to, among others, an increase in offshore deposits by local enterprises operating in the mining sector. These offshore deposits increased by P298.6 million from a reduction of P5.3 billion in the second quarter of the previous period. In addition, local pension fund managers also increased their offshore investments from P1.1 billion to P2 billion during the same period.

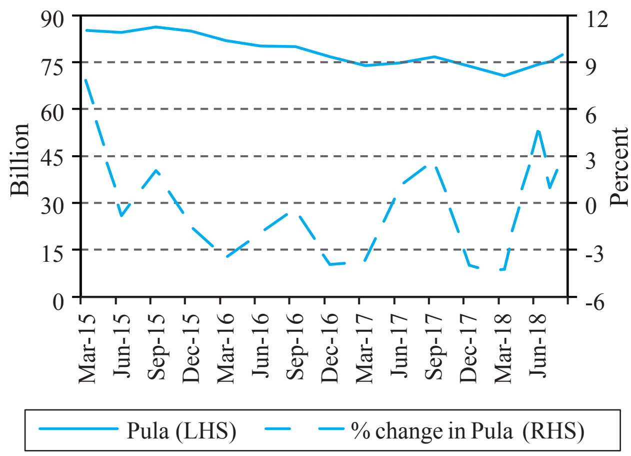
The overall balance of payments recorded a deficit of P5 billion in the twelve months to August 2018, compared to a deficit of P3.1 billion in the corresponding period ending in August 2017. The deficit was mainly a result of foreign exchange outflows, associated with financing of government obligations.

Foreign exchange reserves increase

As at the end of August 2018, the foreign exchange reserves amounted to P77.3 billion, an increase of 0.9 percent from P76.6 billion in August 2017 (Chart 3.9). The increase is largely due to net foreign currency revaluation gains, arising from the depreciation of the Pula against currencies in which the reserves are held.

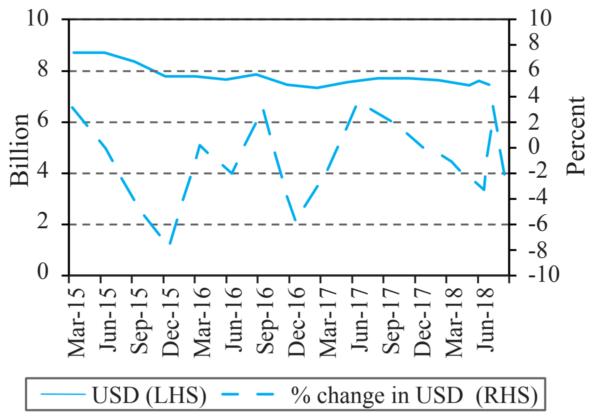
In USD terms, the reserves decreased by 5.3 percent from USD7.6 billion in August 2017 to USD7.2 billion in August 2018 (Chart 3.10). The reserves decreased by 5.6 percent in SDR terms from SDR5.4 billion to SDR5.1 billion in the same period. The decrease in USD and SDR reflects withdrawals of foreign currency to finance government obligations. The import cover for goods and services as at the end of August 2018 was 19 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 Percentage Change



Source: Bank of Botswana

3.6 Exchange rate developments

For 2018, the Bank's implementation of the exchange rate policy (Box 2) entails maintenance of basket weights of the Pula at 45 percent South African rand and 55 percent SDR, and a 0.3 percent downward annual rate of crawl. Consistent with the policy framework, the downward crawl helps to stabilise the real effective exchange rate (REER).

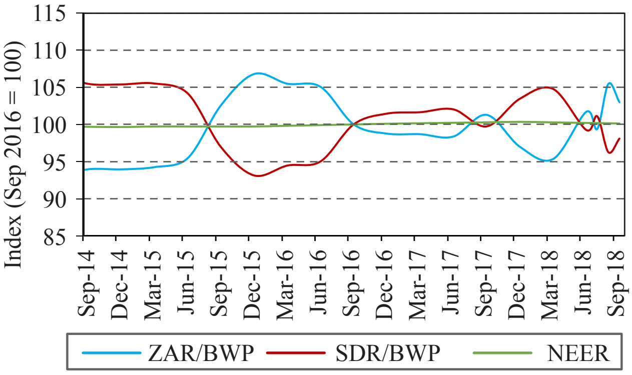
Bilaterally, the Pula appreciated by 1.7 percent against the South African rand and depreciated by 1.6 percent against the SDR over the twelve months to September 2018 (Chart 3.11). Over the same period, it depreciated against all the SDR constituent currencies, except the Chinese renminbi, against which it appreciated by 0.6 percent. It depreciated by 2.7 percent against the US dollar, 2 percent against the Japanese yen, 1.4 percent against the euro and 0.1 percent against the British pound.

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 period, the rand depreciated against the SDR (by 3.3 percent) and all its constituent currencies. It depreciated by 4.3 percent against the US dollar, 3.6 percent against the Japanese yen, 3 percent against the euro, 1.8 percent against the British pound and 1 percent against the Chinese renminbi.

The rand's depreciation against major trading partner currencies, alongside other emerging market (EM) currencies in response to ongoing and anticipated policy normalisation in the advanced economies (notably the US). The narrowing of the interest rate differential between developed and emerging markets, results in reduced investor appetite for EM assets. However, idiosyncratic structural factors and policy weakness in individual EM countries also contribute to currency depreciation and contagion. Notably, the sharp depreciation of the Turkish lira (by about 20 percent against the US dollar) in August 2018 had a contagion effect on all EM currencies, including the rand. The Turkish lira depreciated considerably following the imposition of double tariffs on Turkey's steel and aluminium exports to the US in August 2018, amidst the country's weak economic performance.[3] The rand fell on the back of negative sentiment emanating from, among others, pronouncements by the South African Government on land policy perceived by the market to be inimical to economic performance, the tabling of a bill to make the South African Reserve Bank a state-owned institution and the release of an assessment report by Moody's ratings agency stating that the pace of South African fiscal consolidation is slower than government forecasts, owing to weaker-than-expected economic growth and a rising public sector wage bill.

[3] The Turkish economy is experiencing low economic growth, a high balance of payments deficit and high inflation.

Chart 3.11: Nominal Exchange Rate Indices

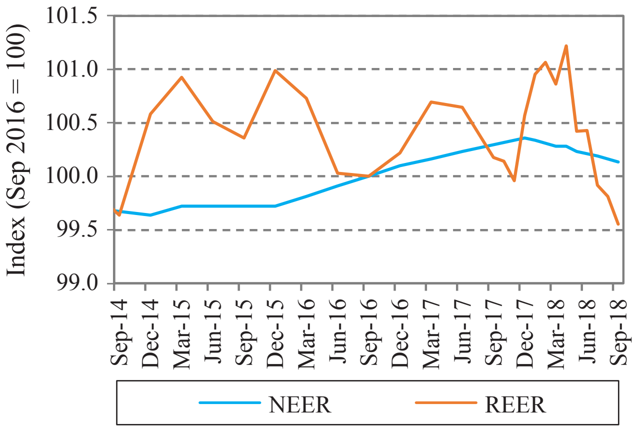


Source: Bank of Botswana

Nominal effective exchange rate (NEER) depreciates

The nominal effective exchange rate of the Pula depreciated by 0.2 percent in the twelve months to September 2018 (Chart 3.12), consistent with the transition from an annual upward rate of crawl of 0.26 percent implemented in 2017 to a downward annual rate of crawl of 0.3 percent, effective January 2018.

Chart 3.12: Nominal and Real Effective Exchange Rates



Source: Bank of Botswana

REER depreciates

The real effective exchange rate (REER) depreciated by 0.6 percent in the twelve months to September 2018 (Chart 3.12), largely reflecting a negative inflation differential between Botswana and trading partner countries in the context of a stable NEER. Average inflation for the trading partner countries was 3.4 percent in the review period compared to 2.9 percent for Botswana. With respect to bilateral movements against the Pula basket currencies, the real Pula exchange rate (using headline inflation) depreciated by 0.2 percent against the South African rand and by 0.9 percent against the SDR. The real exchange rate of the Pula recorded mixed performance against the individual SDR constituent currencies. It appreciated by 1 percent against the Chinese renminbi and 0.4 percent against the British pound and depreciated by 2.1 percent against the US dollar, 0.6 percent against the euro and 0.3 percent against the Japanese yen.

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 of Botswana and the trading partner countries.

3.7 Recent global economic developments

Global growth remains constant
According to the October 2018 World Economic Outlook (WEO), global output is expected to grow by 3.7 percent in 2018, the same as in 2017. The forecast global output growth for 2018 represents a 0.2 percentage points downward revision from the July forecast, reflecting growing trade tensions between the US and its trading partners and stress in emerging markets that have begun to adversely impact on global economic activity. Other downside risks to global economic performance include tighter financial conditions and geopolitical tensions.

Growth in US economic activity accelerates in the second quarter of 2018
For the US, economic growth increased from 2 percent in the first quarter of 2018 to 4.1 percent in the second quarter of 2018, the fastest pace in almost four years. The USD1.5 trillion income tax cut package, which came into effect in January 2018 and fiscal stimulus helped spur economic growth as consumers and government increased spending in the quarter. The forecast of annual GDP growth for 2018 is unchanged at 2.9 percent from the July 2018 WEO Update, and close to the country's 3 percent target, despite the trade tensions between the US and its trading partners. The tax cuts are, however, expected to widen the budget deficit.

Euro zone annual growth weakens
Quarter-on-quarter GDP growth in the euro zone was 0.4 percent in the second quarter of 2018, the same rate of growth as in the first quarter of 2018. Year-on-year to the second quarter of 2018, GDP grew by 2.2 percent, lower than the 2.5 percent in the corresponding period in 2017. The lower annual growth in 2018 reflects lower consumer spending due to higher inflation and sluggish wage growth, as well as lower investor confidence due to trade concerns.

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 slightly 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 continue to be concerns that businesses could relocate jobs and investment to the EU after Brexit.

Emerging markets' growth strengthens

Economic growth improved in emerging market economies, primarily due to 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[4] . China's economy grew by 6.5 percent year-on-year in the third quarter of 2018, easing from 6.7 percent growth in the previous quarter and below market expectations. It was the weakest pace of expansion in almost a decade, amid the intensifying tariff battle with the US and alarming off-balance-sheet borrowings by local governments.

In India, GDP grew by 8.2 percent year-on-year in the second quarter of 2018, above 7.7 percent in the previous quarter and beating market expectations of 7.6 percent. It is the strongest growth since the first quarter of 2016. Faster growth in household spending and inventories contributed to the overall growth of the economy.

South Africa enters a technical recession

South Africa went into a technical recession in the second quarter of 2018, for the first time since 2009, despite optimism over President Ramaphosa's roadmap. Output in South Africa contracted by an annualised rate of 0.7 percent in the second quarter of 2018, following a revised decline of 2.6 percent in the first quarter. The largest negative contributors to GDP growth in the second quarter were the agriculture, transport and trade sectors, which contracted by 29.2 percent, 4.9 percent and 1.9 percent, respectively.

President Ramaphosa recently announced new measures to reignite growth, stimulate economic recovery and secure confidence in sectors affected by regulatory uncertainty and inconsistency. The measures consist of five broad parts: the implementation of growth enhancing economic reforms, reprioritisation of public spending to support job creation, the establishment of an infrastructure fund, addressing urgent and pressing matters in education and health and investing in municipal social infrastructure.

4 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.

Table 3.4: Growth Estimates and Projections

	Estimate		Projection	
	2016	**2017**	**2018**	**2019**
Global	3.3	3.7	3.7	3.7
Advanced economies	1.7	2.3	2.4	2.1
USA	1.6	2.2	2.9	2.5
Euro area	1.9	2.4	2.0	1.9
UK	1.8	1.7	1.4	1.5
Japan	1.0	1.7	1.1	0.9
EMDEs	4.4	4.7	4.7	4.7
China	6.7	6.9	6.6	6.2
Brazil	-3.5	1.0	1.4	2.4
India	7.1	6.7	7.3	7.4
Russia	-0.2	1.5	1.7	1.8
South Africa	0.6	1.3	0.8	1.4
Botswana	4.3	2.4	4.6	3.6

Source: IMF WEO October 2018
Note: EMDEs stands for emerging market and developing economies.

Global commodity prices

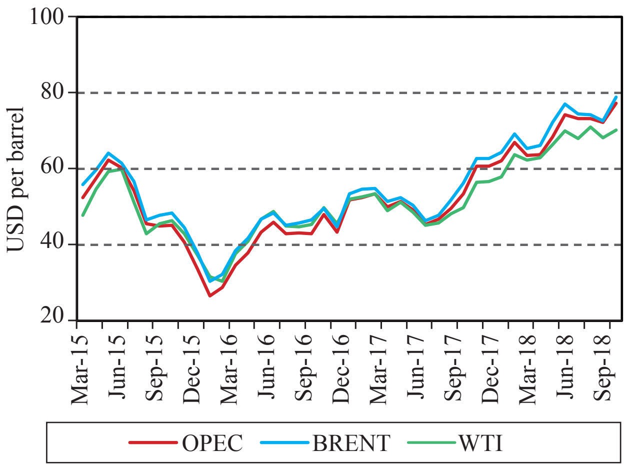
Diamond prices decrease

The global rough diamond price index declined by 3 percent in the third quarter of 2018, compared to an increase of 3 percent in the second quarter, reflecting trade tensions between the US and China. Polished diamond prices also decreased.

Oil prices increased in the third quarter of 2018

International oil prices increased to above USD70 per barrel in the third quarter of 2018, thus much higher compared to around USD50 per barrel in the third quarter of 2017. The OPEC reference crude oil basket price averaged USD74.23 per barrel in the third quarter of 2018, while the price of Brent crude averaged USD75.20 per barrel in the third quarter of 2018. The OPEC price was USD77.18 per barrel while Brent oil futures reached USD80 per barrel in September 2018, influenced by prospects of a shortfall in supply arising from sanctions against major crude exporter, Iran. Overall, developments in the international oil market imply marginal upward pressure on Botswana inflation.

Chart 3.13: Oil Prices (Monthly Averages)

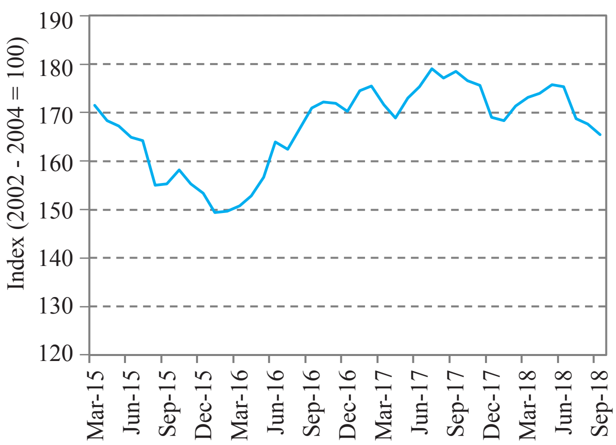


Source: OPEC and US Energy Information

Food prices decreased in the third quarter of 2018

According to the United Nations Food and Agriculture Organisation (FAO), global food prices decreased by 6.4 percent in the third quarter of 2018, compared to an increase of 7 percent in the corresponding period ending in 2017 (Chart 3.14). The lower international prices of cereal, vegetable oils, dairy and meat contributed to the decline, while the price of sugar increased during the same period. The food price index averaged 165.4 points in September, down by 1.4 percent from August 2018 and 7.4 percent lower compared to September 2017. In Southern Africa, food prices are expected to increase at a faster pace due to reduced crop production, following drought 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

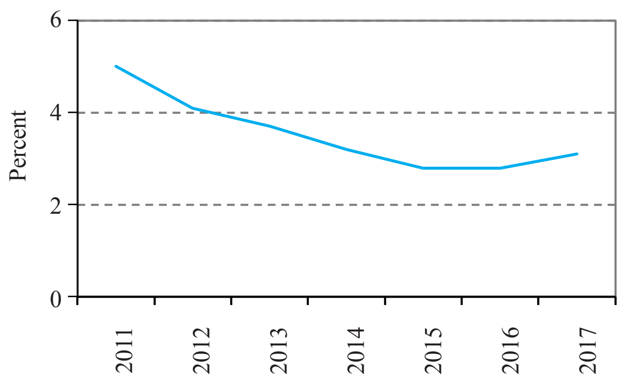


Source: Food and Agriculture Organisation

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, notably the euro zone, India and the US. South Africa's headline inflation averaged 5 percent in the third quarter of 2018 and was higher than the average of 4.8 percent in the corresponding quarter in 2017. South Africa's headline inflation was 4.9 percent in September 2018 and has remained within the South African Reserve Bank's target range of 3 – 6 percent since April 2017.

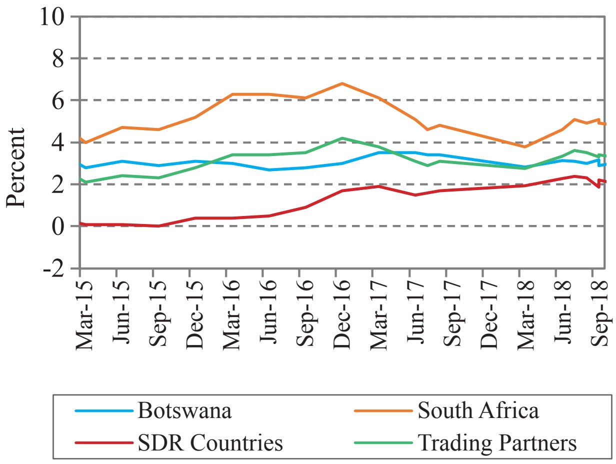
Chart 3.15: Global Inflation



Source: Bloomberg

Meanwhile, the average trade-weighted inflation for Botswana's trading partners decreased from 3.5 percent in August 2018 to 3.4 percent in September 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 England (BoE) maintained their ultra-accommodative monetary policy stances, particularly asset purchases and low policy rates. The US Federal Funds Rate range was increased from 1.75 - 2 percent to 2 - 2.25 percent in September 2018, as risks to the economic outlook were considered to be somewhat balanced. The Bank of Japan (BoJ) maintained its policy rate at -0.1 percent. The BoJ intends to maintain the current extremely low levels of interest rates for an extended period of time, taking into account uncertainties regarding economic activity and prices, including the effects of the consumption tax hike scheduled for October 2019.

Meanwhile, in emerging market economies, central banks maintained key policy rates, except the Central Bank of Russia, which raised the key rate by 0.25 percentage points to 7.5 percent in September 2018, in response to accelerating inflation. The Bank of Brazil maintained its policy rate at 6.5 percent in September 2018, in the context of a positive inflation outlook. Similarly, against market expectations, the Reserve Bank of India maintained its policy rate at 6.75 percent in October 2018, due to the positive inflation outlook resulting from benign food prices. The People's Bank of China maintained its policy rate at 4.35 percent at the third quarter of 2018 MPC meeting, in the context of stable growth momentum with strong resilience. However, the People's Bank of China reduced the primary reserve requirement from 15.5 percent to 14.5 percent to boost liquidity in the banking system. The South African Reserve Bank also maintained its policy rate at 6.5 percent at the September 2018 MPC meeting; however, the MPC remained concerned about the deteriorating inflation outlook due to supply side factors.

Table 3.5: Monetary Policy Decisions

Central Bank	Latest Meeting	Current Policy Rate (Percent)	Change from Previous Meeting
Bank of Botswana	October 2018	5.00	No change
South African Reserve Bank	September 2018	6.50	No change
US Federal Reserve	September 2018	2.00 - 2.25	Increase by 0.25 percentage
BoE	September 2018	0.75	No change
ECB	September 2018	0.00	No change
BoJ	September 2018	-0.10	No change
People's Bank of China	September 2018	4.35	No change

4. THE ECONOMIC AND POLICY OUTLOOK

4.1 Global economic prospects

Projections for global growth have been revised downwards for the first time in more than two years, owing to outlook deterioration in some emerging market economies, after a weak performance in the first quarter of 2018 in several advanced economies as well as the escalating trade tensions between the US and its trading partners. Meanwhile, global growth remains solid but has become less balanced. However, the outlook remains positive, mainly supported by accommodative monetary and fiscal policies in advanced economies. For emerging market and developing economies (EMDEs), downward revisions were higher due to visible signs of lower investment spending and manufacturing activity, alongside weaker trade growth. In addition, the IMF also cut its outlook for China as a result of the ongoing tariff war with the US. In South Africa, the growth outlook is expected to remain subdued on account of structural bottlenecks due to the slow economic reform agenda and the widening fiscal account deficit. With regard to the inflation outlook, projections indicate that global inflation will accelerate, largely due to the anticipated increase in commodity prices.

Global economic outlook revised downwards

According to the October 2018 WEO, global output is expected to expand by 3.7 percent in both 2018 and 2019, a downward revision of 0.2 percentage points from the July 2018 WEO Update. The downward revision is mainly due to trade disputes between the US and its trading partner countries, particularly China, which is expected to weigh down on the world's output.

For advanced economies, the output growth forecast for 2018 remains above trend at 2.4 percent, but is expected to fall to 2.1 percent in 2019. Average growth in most advanced economies is expected to decline to below pre-global financial crisis averages. Slower expansion in the working-age population and projected lacklustre productivity gains are the prime drivers of the expected lower medium-term growth rates. Risks to global growth are skewed to the downside in a context of elevated policy uncertainty, rising trade barriers and a reversal of capital flows from emerging market economies with weaker fundamentals and higher political risk.

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 anticipated weakness is more pronounced in consumption expenditure, reflecting the erosion of purchasing power occasioned by the increase in inflation. Moreover, prospects of a no deal Brexit[5] have increased, adding further to the negative sentiment surrounding Brexit.

Positive economic outlook for US

For the US, growth forecast for 2018 was unchanged at 2.9 percent. However, the forecast for 2019 was revised downwards by 0.2 percentage points to 2.5 percent, reflecting the impact of the recently announced trade measures, and the impact of tariffs imposed on US imports from China.

Growth for the euro zone to slow down

In the euro zone, economic growth is projected to ease from 2.4 percent in 2017 to 2 percent in 2018 and to decline further to 1.9 percent in 2019. In 2018, weaker-than-expected outturns in the first half of the year have led to downward revisions for the euro area. The German economy is expected to continue growing robustly in the second half of 2018, propelled by stronger domestic demand. Similarly, economic activity in France is projected to accelerate in the second half of the year as household spending benefits from stronger employment and gets a moderate boost from fresh income tax cuts.

Sentiment remains positive in Italy. Although Italy's level of employment dropped, the unemployment rate in July 2018 was the lowest in the past six years, thus supportive of increased consumer spending. However, the ongoing 2019 budget negotiations continue to worry investors, as interest rates on Italian bonds remain extremely sensitive to the government's announcements of the future fiscal stance. In addition, potential financial instability in Italy and escalating trade tensions between the EU and the US could erode the outlook further.

[5] A situation whereby the UK and the European Union are unable to reach a withdrawal agreement.

Slower growth in emerging markets

Meanwhile, in emerging market and developing economies, growth in economic activity is expected to weaken, reflecting several factors, including tighter financial conditions, geopolitical tensions and higher oil prices. Moreover, the weaker growth reflects the anticipated negative impact of tariffs implemented by the US on imports from China and other economies in emerging Asia. Emerging markets experienced larger volumes of capital outflows, as investors shifted their money out on the back of expected higher interest rates in the US. In addition, much weaker activity in Iran, following the re-imposition of US sanctions, and a sharp projected slowdown in Turkey, following the ongoing market turmoil, also contributed to the downward revision. Nonetheless, for oil exporters, higher oil prices have boosted growth prospects. Overall, output growth in emerging market and developing economies was revised downwards from 4.9 percent to 4.7 percent and from 5.1 percent to 4.7 percent in 2018 and 2019, respectively.

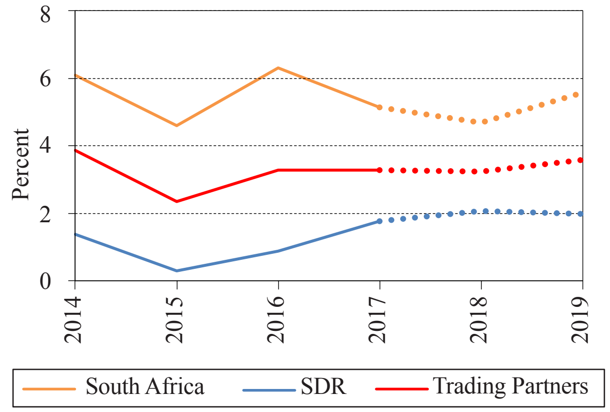
Growth in the South African economy to remain subdued

Growth prospects in South Africa are expected to remain subdued as output projections are weighed down by the widening fiscal account deficit and a slow reform agenda. Output growth has been revised downwards by 0.7 percentage points to 0.8 percent and by 0.3 percentage points to 1.4 percent for 2018 and 2019, respectively. However, the economy is likely to be revived by the recently announced stimulus package, with which the government intends to re-prioritise spending, establish an infrastructure fund and remove some regulatory restrictions, including in tourism, in order to boost economic growth and reduce unemployment. Furthermore, investor confidence is expected to improve following the recent appointment of Mr Tito Mboweni, the former Governor of the South African Reserve Bank as Minister of Finance.

Global inflation to increase

Globally, the inflation outlook remains favourable in 2018, although there are indications of emerging upside pressures, partly emanating from higher oil prices. Global inflation is forecast to increase from 3.2 percent in 2017 to 3.8 percent in 2018. Meanwhile, in South Africa, inflation forecasts have been maintained at 4.8 percent for 2018, as the impact of the increase in value-added tax (VAT) on inflation continues to be muted. However, the weaker rand exchange rate and the expected higher oil price have resulted in a slight upward revision of the inflation forecast for 2019, from 5.6 percent to 5.7 percent, but remaining within the SARB's target range in the short-to-medium term (Chart 4.1).

Chart 4.1: South Africa and SDR Headline Inflation

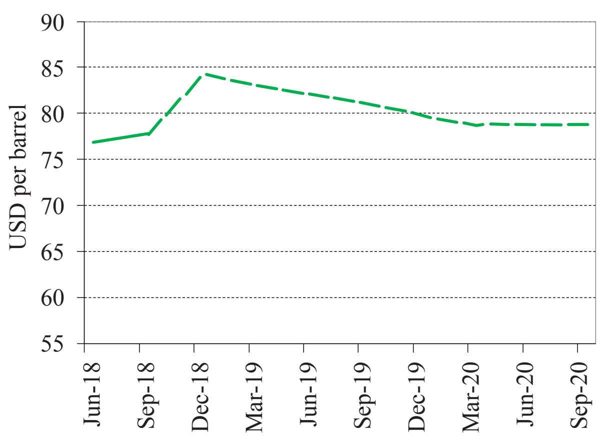


Source: SARB and Bloomberg

Commodity prices to fall

While international oil prices are expected to remain relatively stable in the last quarter of 2018 (Chart 4.2), the political and economic crises affecting the oil-rich Venezuela, have resulted in a reduction in its crude oil production, which is expected to tighten oil markets much quicker than previously anticipated and push prices up. Furthermore, the US will apply sanctions to halt oil exports from Iran, starting in November 2018, and loss of this supply may result in a surge in crude oil prices. Nonetheless, with the escalation of the tariff tensions between China and the US, it is anticipated that growth in global trade will slow down, causing the demand and, hence, oil prices to fall. Overall, developments in the international oil market imply modest upward pressure on domestic inflation.

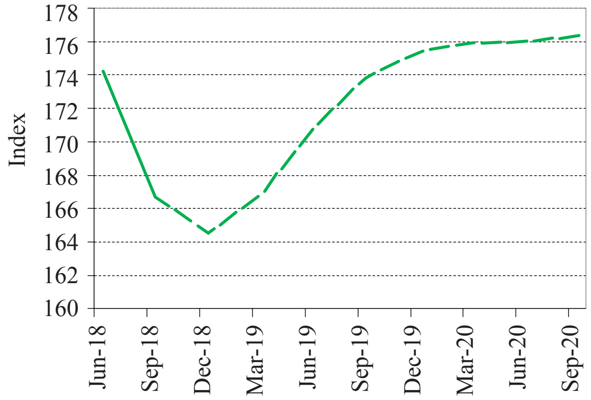
Chart 4.2: International Oil Prices



Source: Bloomberg

Food prices are likely to fall in the fourth quarter of the year due to the projected sharp fall in international maize and wheat prices. Thereafter, food prices are expected to trend upwards (Chart 4.3).

Chart 4.3: International Food Prices
FAO Index



Source: Bloomberg

4.2 Outlook for domestic economic activity

The projected steady growth in the global economy is expected to benefit the diamond market. Hence, domestic output growth is projected to increase in the short to medium term. Furthermore, the projected accommodative monetary conditions and growth in government expenditure in the 2018/19 fiscal year, the stable water and electricity supply, as well as government economic diversification initiatives, 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 growth 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.

It is expected that growth in non-mining output will increase in 2018 and 2019, reflecting better performance of the non-mining sectors (see Box 3 for more details), including the expected increase in De Beers Global Sightholder Sales output due to improved global demand and higher prices for rough diamonds. 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 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 stimulate the economy going forward.

Meanwhile, the imposition of tariffs on USD 200 billion worth of imports from China by the US and retaliatory actions by China have begun to hurt the world's economic activity. This trade war could result in a fall in global demand and commodity prices, including for rough diamonds, and impact negatively on the domestic economic outlook.

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. For example, 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 an improved business confidence level consistent with the recent Business Expectations Survey (BES). FinTech developments, such as electronic and cell phone 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 will boost the construction sector and, ultimately, industries will 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 Masama Coal Mine.
- 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 resulting from good grazing conditions following heavy rains experienced at the beginning of the year.
- Reform of Botswana Meat Commission (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.
- Establishment of the Botswana Energy Regulatory Authority (BERA) to promote sustainable and secure energy supply across the country.
- Continued Government efforts to increase water supply across the country, such as the Emergency Water Security and Efficiency Project.

Agriculture

- Livestock production expected to improve on account of continued efforts to contain foot and mouth disease outbreaks and government subsidy through the Livestock Management and Infrastructure Development (LIMID) project.
- Crop production expected to benefit from 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 forecasts headline inflation to remain within the 3 - 6 percent medium-term objective range in the short to medium term. Compared to the August 2018 forecast, inflation is projected to be lower in the short term, but higher in the medium term, due to the upward revision of international oil prices and South African inflation. The main downside risk to the inflation outlook relates to any significant reduction in government levies and weak demand, which can 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, international oil and food prices, as well as government levies and taxes beyond current forecasts.

Inflation projected to remain within the objective range

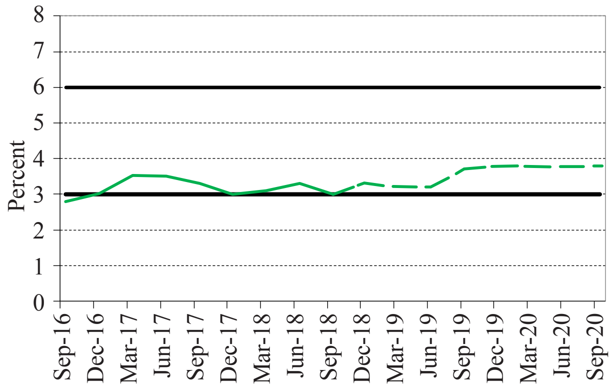
Headline inflation is projected to be stable in the short term, but to increase marginally in the medium term; although remaining within the Bank's medium-term objective range of 3 - 6 percent (Chart 4.4).

The projected low inflation in the short term reflects the downward revision of the alcohol levy from 55 percent to 35 percent in the fourth quarter of 2018 and the below-potential domestic economic activity. However, it is unlikely that the impact of the lower alcohol levy will be fully realised in the fourth quarter of 2018, given concerns by the Botswana Alcohol Industry Association (BAIA) that the current stock of alcohol was bought at higher prices and thus needs to be exempt from the levy adjustment.

The projection also takes into account the impact of the increase in domestic fuel prices on inflation on October 2018. The increase in petrol, diesel and illuminating paraffin prices in October 15, 2018 by 65 thebe, 73 thebe and 63 thebe, translates to an increase in pump prices by 7.7 percent, 8.7 percent and 8.7 percent, respectively.

The projected increase in inflation in the medium term is mainly driven by the upward revision in the forecast for South African inflation and international oil prices.

Chart 4.4: Botswana Headline Inflation Forecast



Source: Bank of Botswana

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 (Box 4) and subdued growth in economic activity. However, there are prospects for improvement in the domestic economy supported by accommodative real monetary conditions (RMCI)[6]. Nonetheless, it is expected that the economy will operate below potential in the forecast period.

[6] 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.

Box 4: Wage Growth and Inflation Analysis

Botswana is in a low inflation environment and recent projections indicate that it could stretch on for another two years or longer. Since 2015, inflation has been lingering around 3 percent, the lower bound of the medium-term inflation objective range. Some of the main forces behind this persistently low inflation are modest global (trading partner) inflation, the relative strength of the Pula against the rand (which makes imports cheaper), benign oil and food inflation and the general restrained growth in domestic economic activity. This has implications for inflation expectations and future wage growth. When inflation is low, as is currently the case, inflation expectations tend to be low[7] and, thus, this reinforces low wage growth. Therefore, the low inflation prospects suggest that the nominal wage growth is likely to continue to be around the 3 percent to 4 percent range, as in the recent past. However, should growth in nominal wages rebound, maintaining positive real wage growth would have to be accompanied by a sustained increase in productivity in order to counteract wage-push inflation. Even so, it is unlikely that domestic demand pressures would rise substantially in the near term, given that the economy is currently operating below its potential level.

Meanwhile, according to the Business Expectations Survey of March 2018, businesses expect inflation to remain within the objective range in the medium term.

Core inflation to increase in the medium term

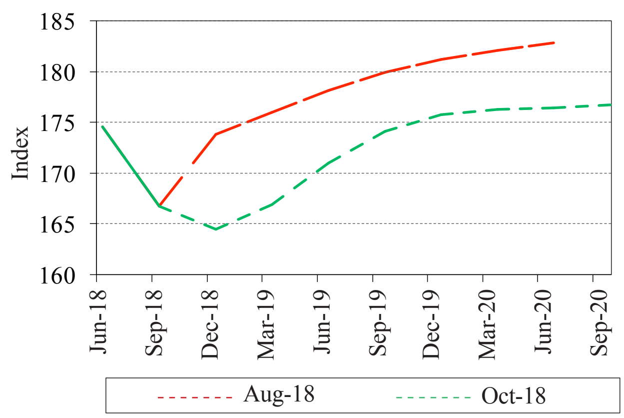
Core inflation (inflation excluding food and fuel prices) is forecast to increase steadily in the medium term, reflecting, in part, the potential improvement in non-mining economic activity.

International food prices to increase from 2019

International food prices are projected to continue to fall in the fourth quarter of 2018, but thereafter trend upwards in the rest of the forecast horizon. The high chance of the El Nino condition during the 2018/19 ploughing season, giving rise to the expected low harvest, contributes to the forecast higher food prices in the medium term (Chart 4.5).

Compared to the August 2018 forecast, international food prices have been revised slightly downwards in the entire forecast horizon. The lower forecast relative to August 2018 reflects projected lower sugar prices as a result of the continued depreciation of the currencies of Brazil and India (the two major sugar suppliers) against the US dollar.

Chart 4.5: International Food Prices (FAO Index)



Source: Bloomberg

International oil prices to remain stable

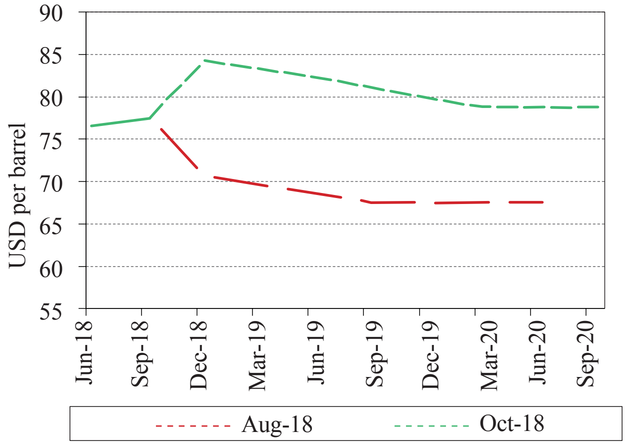
International oil prices are projected to increase in the last quarter of 2018, but to be relatively stable in the forecast horizon. The price of Brent crude oil is expected to gradually fall from around USD84.2 per barrel in the last quarter of 2018 to close to USD80 per barrel at the end of 2019 (Chart 4.6).

Compared to the August 2018 forecasts, international oil prices have been revised upwards, driven by strong demand and renewed US sanctions against a major OPEC exporter, Iran.

Other OPEC countries have signalled the possibility of extending the 2017 agreement to limit output. Nonetheless, Russia and Saudi Arabia are wary of the prices rising enough to dent demand, whilst the economic crisis in Venezuela continues to limit the country's output.

[7] The March 2018 Business Expectations Survey projects low inflation for Botswana in 2018 and 2019; 3.5 percent and 3.7 percent, respectively.

Chart 4.6: International Oil Prices



Source: Bloomberg

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

Inflation forecast revised upwards in the medium term

Since the August 2018 MPC, GDP for the second quarter of 2018 and inflation for the third quarter of 2018 have been released. There has also been an adjustment in domestic fuel prices and the alcohol levy, while assumptions on prospective external developments have changed. The adjustments in administered prices and revisions in external assumptions have led to a lower inflation projection in the short term, but higher projected inflation in the medium term, compared to the August 2018 forecast. In particular, the combined effect of the reduction in the alcohol levy by 20 percentage points and the potential persistence of low domestic inflation observed in the third quarter of 2018 are expected to exert downward pressure on inflation in the short term, and offset the impact of the recent increase in domestic fuel prices. The higher inflation projection in the medium term mainly reflects the upward revision in international oil prices and South African inflation forecasts.

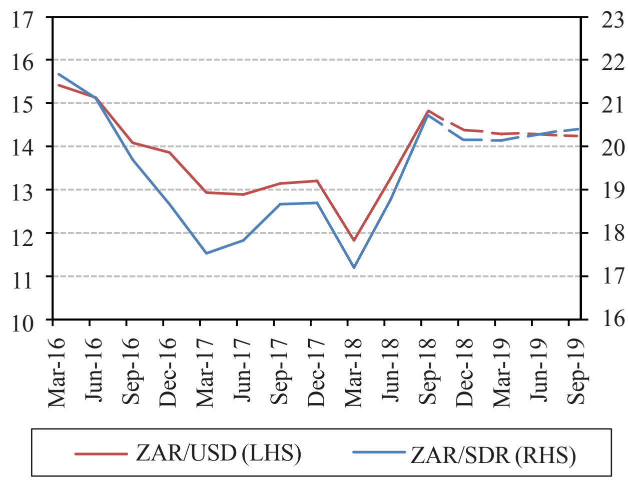
Exchange rate movements

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 appreciate in the next four quarters (Chart 4.7), as emerging market currencies are expected to receive a boost from measures taken by their central banks to stabilise their respective currencies. Argentina, Turkey, India and Indonesia are among the emerging market countries expected to move towards monetary policy tightening. In South Africa, markets are pricing-in the possibility of an interest rate hike this year, following the hawkish statement by the South African Reserve Bank's Governor after the September 2018 MPC meeting.

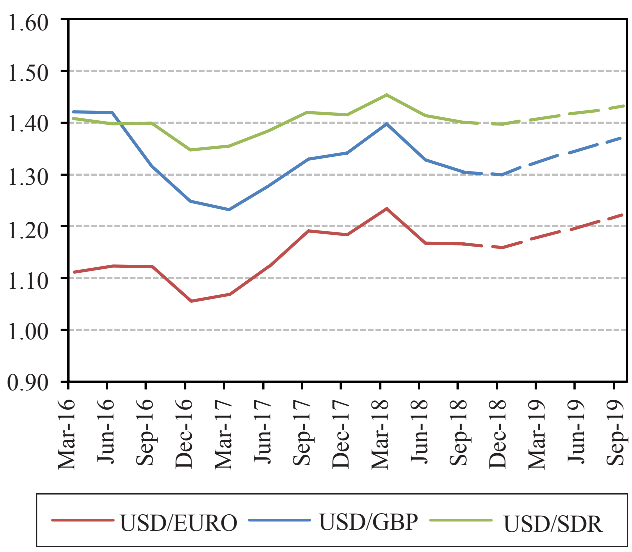
The rand is, therefore, expected to appreciate marginally against major international currencies in the next four quarters (Chart 4.7). Consequently, the Pula is expected to depreciate marginally against the rand in the same period.

Chart 4.7: ZAR against USD and SDR



Source: Reuters

Chart 4.8: Exchange Rates against USD



Source: Reuters

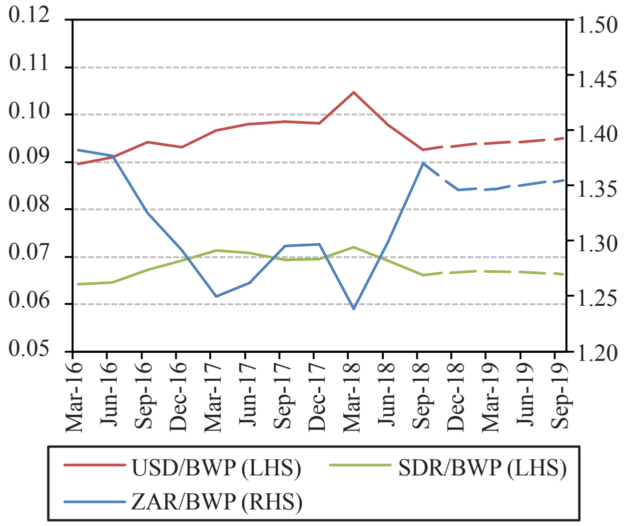
The US dollar is expected to depreciate against other major international currencies in the next four quarters (Chart 4.8), due to the expected huge US budget deficit arising from increased government spending and large corporate tax cuts. These fiscal stimuli are expected to buoy the economy only moderately. The dollar is also likely to weaken because the US economic growth momentum has now peaked and the market has already priced-in the Federal Reserve's policy tightening and the global trade war; all of which undermine the appeal of the currency. Furthermore, other major central banks are moving 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 the US dollar due to growing expectations of a business-friendly Brexit deal. There are hopes that the EU and the UK will eventually arrive at a mutually beneficial and business-friendly trade deal. Meanwhile, the euro is expected to appreciate against the US dollar owing to monetary policy normalisation; the ECB is likely to move towards policy tightening, as inflation is above the Governing Council's target of 2 percent.

The Japanese yen is expected to appreciate against the US dollar owing to its safe haven status during times of global economic distress, amidst the struggling US dollar. The currency has been used by investors to hedge against tensions in emerging markets and the risks to the Chinese economy from the US tariffs. The Chinese renminbi is expected to depreciate against the US dollar on the back of the escalating trade war between the US and China. Overall, forecast movements of the SDR constituent currencies would result in a slight appreciation of the SDR against the US dollar (Chart 4.8).

The anticipated appreciation of the rand against major currencies is, however, expected to exert marginal upward pressure on the Pula against the SDR constituent currencies in the forecast horizon (Chart 4.9). The expected slight depreciation of the Pula against the rand is likely to have a minimal effect on the domestic inflation outlook.

Chart 4.9: BWP Exchange Rates against ZAR, USD and SDR



Source: Reuters and Bank of Botswana calculations

Risks generally balanced

Risks to the inflation outlook are the same as those identified at the August 2018 MPC meeting. On the domestic front, upside risks to the inflation outlook relate to any unanticipated substantial increase in administered prices and/or government levies and taxes. Externally, any increase in international commodity prices beyond current forecasts may exert upward pressure on domestic inflation.

However, there are downside risks associated with restrained global economic activity, the tendency of technological progress to lower costs and prices and the potential fall in commodity prices. Moreover, the protectionist policies by the US that have triggered retaliatory actions by China and the EU are likely to have a negative impact on global trade and, in turn, global investment and economic growth. Domestically, the continuance of modest GDP growth and restrained increase in incomes could lead to subdued inflation.

5. OCTOBER 2018 MONETARY POLICY COMMITTEE DECISION

At the meeting held on October 22, 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 fell from 3 percent in August to 2.9 percent in September 2018, marginally below the lower bound of the objective range.

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 inflation outlook.

Real GDP grew by 4.4 percent in the twelve months to June 2018, compared to a slower rate of expansion of 3.2 percent in the year to June 2017. The improvement in performance reflects the recovery in the mining sector, which grew by 5.6 percent compared to a contraction of 10 percent in the previous year. Growth in non-mining GDP moderated to 4.3 percent in June 2018, from 5 percent in June the previous year. GDP growth is projected to improve further in the short to medium term, driven largely by performance of the services sectors and recovery in mining activity, in line with positive global economic prospects. Furthermore, the projected accommodative monetary conditions in the domestic economy and increase in government expenditure, as well as relative stability in water and electricity supply, are expected to support economic activity in the non-mining sectors. Overall, it is anticipated that the economy will operate close to, but below full capacity in the medium term, thus posing no risk to the inflation outlook.

Global output growth is projected at 3.7 percent in 2018 and 2019, the same as in 2017. Protectionist trade policies, the potential build-up of financial vulnerabilities induced by easy financial conditions, geopolitical tensions and higher oil prices could negatively affect the medium-term growth prospects. Regionally, GDP growth in South Africa is projected at 0.8 percent in 2018, down from 1.3 percent in 2017, and is forecast at 1.4 percent in 2019. Economic prospects in South Africa are expected to improve, following the recently announced stimulus package with which the government intends to re-prioritise spending and remove some of the regulatory restrictions hampering performance and employment creation.

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.

The last MPC meeting of the year will be held on December 4, 2018, at which dates of MPC meetings for next year will be announced.