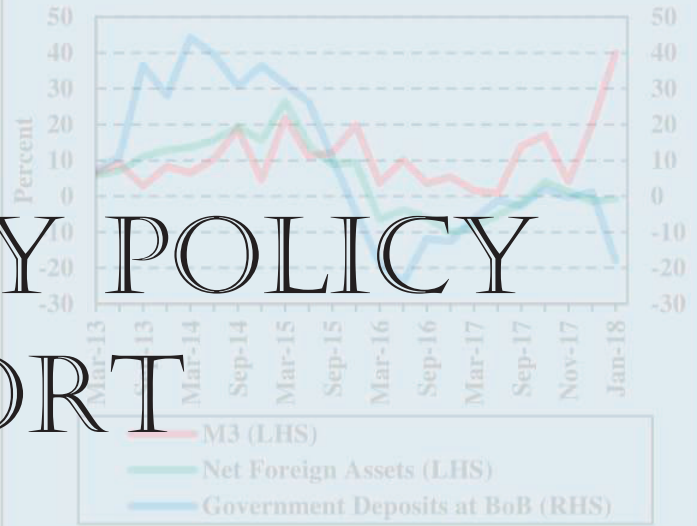


3.3 Monetary developments

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.: Year-on-Year Growth in Money Supply



MONETARY POLICY REPORT

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



Source: Commercial Banks, Bank of Botswana



accelerates

in money supply (M3) 7 percent in December 2017 and 7 percent in January 2018 (Chart 3.3). This was partly due to the expansionary effect of the growth of Government Deposits at the Bank of Botswana, which was offset by a decline in growth of net

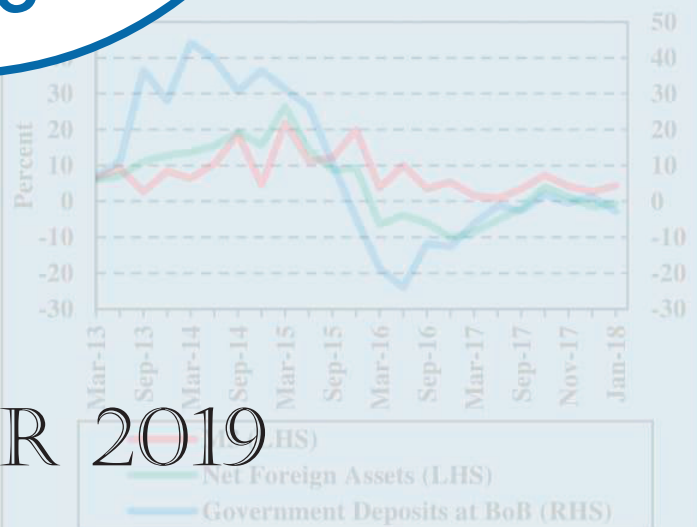
Credit growth remains stable

Annual growth in commercial banks' credit remained the same (4.9 percent) in January 2018 as in the previous month (October 2017). 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

OCTOBER 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 Monetary Policy Committee (MPC). The MPR presents the Bank's review of economic and inflation trends as well as policy performance. The report also provides an assessment of economic and financial developments that are likely to influence the inflation path in the medium term and, in turn, the Bank's future policy choices. In this respect, the MPR promotes an understanding of the conduct of monetary policy in order to anchor public expectations of a low, predictable and sustainable level of inflation.

1.2 Monetary policy framework

The primary objective of the Bank's monetary policy is to achieve price stability. For Botswana, price stability is defined as a 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 the international competitiveness of domestic producers of tradeable goods and services. The Ministry of Finance and Economic Development (MFED), in consultation with the Bank, makes a recommendation on the parameters of the exchange rate mechanism (weights of currencies that comprise the Pula Basket and the rate of crawl) that determine the value of the Pula, for approval by His Excellency, the President. In addition, the Bank uses the Bank Rate to influence short-term interest rates to steer the economy through business cycles, thus contributing to sustainable economic development.

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

The monetary policy stance is signalled by the Bank Rate. To support this signal, the Bank uses open market operations, which entail, primarily, auctioning of Bank of Botswana Certificates 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 being 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. Hence, the Bank Rate was maintained at 4.75 percent at the October 2019 MPC meeting. The last policy change was in August 2019, when the Bank Rate was reduced by 25 basis points from 5 percent to 4.75 percent.

The risks to the inflation outlook are assessed to be generally balanced. Upside risks to the outlook relate to any unanticipated substantial upward adjustments in administered prices and government levies and/or taxes, and any increase in international commodity prices beyond current forecasts. The downside risks are associated with restrained global economic activity and modest growth in the domestic economy.

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 2.9 percent in the third quarter of 2019, a decline from an average of 3 percent in the third quarter of 2018, accounted for, in part, by the slower increase in the cost of electricity, transport, insurance, as well as rentals. Inflation is expected to remain below the lower bound of the Bank's objective range for the remainder of 2019, but to revert within the objective range in the second quarter of 2020.

Gross domestic product (GDP) grew by 3.9 percent in the year to June 2019, compared to a faster expansion of 4.9 percent in the corresponding period in 2018, mainly attributable to a deceleration in output growth of the mining sector. Growth in non-mining GDP also slowed in the review period. Output growth is projected at 4.3 percent and 4.6 percent in 2019 and 2020, respectively, supported by the non-mining sector, particularly the services sectors; trade, hotels and restaurants, transport and communications and finance and business services. It is further anticipated that ongoing structural reforms such as improving the ease of doing business, and concerted efforts aimed at transforming the economy from a resource-based to a knowledge-based economy will have a positive impact on economic activity. However, it is projected that non-mining economic performance will continue below potential.

Annual growth in commercial bank credit slowed to 6.1 percent in September 2019 from 8.1 percent in the corresponding period in 2018, reflecting, in part, the decline in lending to the business sector as a result of decreased utilisation of existing credit facilities, as well as loan repayments by some companies in manufacturing, finance, trade industries and parastatals. Meanwhile, growth in household loans increased due to higher demand, particularly for unsecured lending, influenced by the recent increase in public services salaries, as well as the increase in bank funding/liquidity indicated by growth in customer deposits.

At the end of August 2019, foreign exchange reserves amounted to P73.4 billion, a decrease of 5 percent from P77.3 billion in August 2018. The decrease mainly reflects the drawdown on foreign exchange reserves to fund government expenditure and imports. The current account of the balance of payments recorded a smaller surplus of P846 million in the second quarter of 2019, compared to P3.8 billion during the same period in 2018, influenced by the lower merchandise trade balance.

The nominal effective exchange rate (NEER) of the Pula appreciated by 0.1 percent in the twelve months to September 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, being implemented in 2019. The Pula appreciated against the South African rand, but depreciated against the SDR in the twelve months to September 2019. The Pula depreciated against most of the SDR constituent currencies, influenced by

performance of the South African rand against those currencies. Meanwhile, in the year to August 2019, the real effective exchange rate (REER) appreciated by 0.3 percent because of higher inflation in Botswana than in trading partner countries, and the slight appreciation of the NEER reflecting the impact of the upward rate of crawl that is being implemented.

Global economic output grew by 3.6 percent in 2018 and it is anticipated to ease to 3 percent in 2019, mainly due to the adverse impact of heightened trade tension between the US and China, macroeconomic strain in several emerging market economies as well as structural factors such as low productivity growth and aging population in advanced economies. US GDP growth slowed down from 3.1 percent in the first quarter of 2019 to 2 percent in the second quarter, reflecting the effects of trade war between the US and China. GDP in the United Kingdom (UK) contracted for the first time since 2012 in the second quarter of 2019 due to a decline in inventories and the shutdowns in the car industry associated with Brexit uncertainty. 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 expanded by an annualised 3.1 percent in the second quarter of 2019, driven by the mining, finance and trade sectors.

The global rough diamond price index decreased in the third 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) decreased to slightly above USD60 per barrel in the third quarter of 2019 from above USD65 per barrel in the second quarter of 2019, reflecting the prospect of continued trade war between the US and China, which has negatively affected global economic growth, thereby the demand for oil. Meanwhile, the United Nations' Food and Agriculture Organisation (FAO) food price index increased in the third quarter of 2019, as prices of sugar and meat rose.

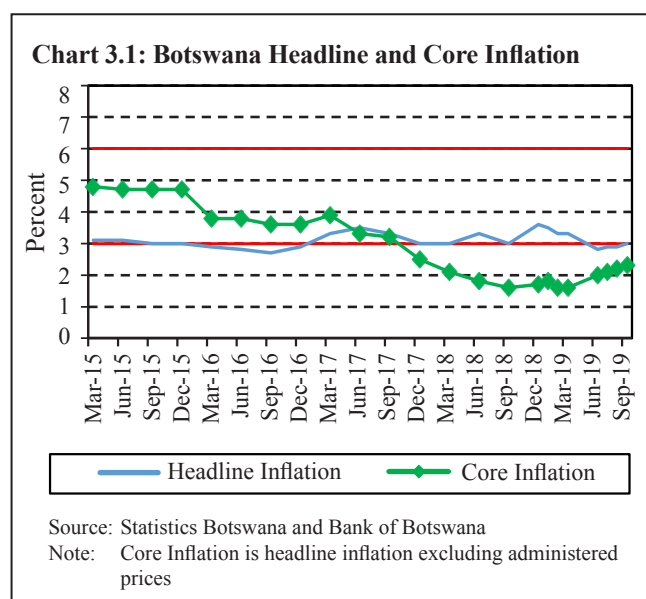
3. RECENT ECONOMIC DEVELOPMENTS

3.1 Inflation environment¹

Headline inflation decreases in the third quarter of 2019

Headline inflation averaged 2.9 percent in the third quarter of 2019 and was lower than the 3 percent average inflation in the third quarter of 2018 (Table 3.1), accounted for, in part, by the slower increase in the cost of electricity, transport, insurance and rentals.

The 2.9 percent average inflation for the third quarter of 2019 was slightly above the 2.8 percent earlier forecast for the quarter.



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

The trimmed mean inflation (CPITM) decreased to 2.7 percent in the third quarter of 2019, from 3 percent in the third quarter of 2018, while core inflation, excluding administered prices (CPIXA), rose to 2.2 percent from 1.6 percent in the same period (Table 3.1). Box 1 discusses administered prices. Inflation excluding food and fuel (CPIXFF) averaged 3 percent in the third quarter of 2019, higher than the 2.1 percent in the corresponding quarter of 2018 (Table 3.1), influenced by higher prices of vehicles and alcoholic beverages in the same period.

¹ Statistics Botswana rebased the CPI from September 2016 to December 2018.

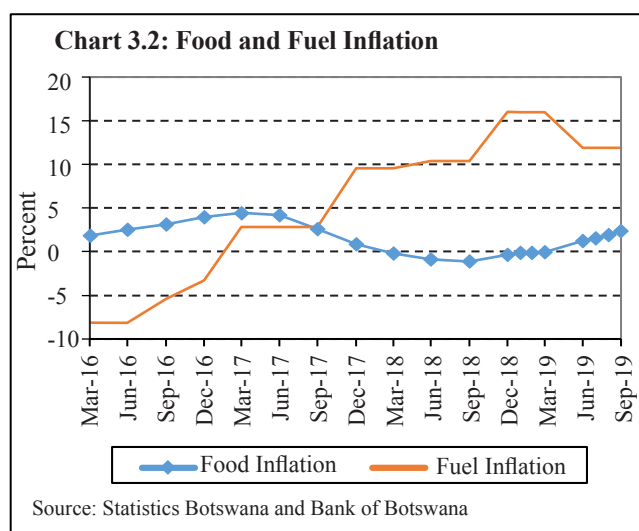


Table 3.1: Annual Price Changes for Categories of Goods and Services (Percent)

Category of commodities	Basket Weights	September 2019	Q3 2019	Q3 2018
Food and non-alcoholic beverages	13.6	2.5	2.0	-1.1
Alcoholic beverages and tobacco	4.3	3.6	3.6	0.8
Clothing and footwear	6.0	1.2	1.1	1.8
Housing, water, electricity, gas and other fuels	17.5	1.6	1.7	3.5
Furnishing, h/h equipment and routine maintenance	4.9	2.1	2.2	2.0
Health	3.4	0.9	1.0	0.9
Transport	23.4	6.2	6.1	7.5
Communications	6.9	0.0	0	-8.5
Recreation and culture	2.8	0.1	0.1	1.9
Education	4.6	3.2	3.2	5.4
Restaurants and hotels	3.7	2.4	2.3	3.5
Miscellaneous goods and services	9.0	5.1	5.0	7.5
Annual Inflation (All items)	100.0	3.0	2.9	3.0
CPITM		2.7	2.7	3.0
CPIXA		2.3	2.2	1.6
CPIXFF		2.1	2.1	3.0

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

Box 1: Administered Prices

Administered price items in the consumer price index (CPI) basket are goods or services for which prices are set or controlled by the Government outside the normal free market price determination. These price adjustments are however, to some degree, influenced by general price developments. For example, cost adjustments in some administered prices are often justified as a way of catching up with market prices, a response to higher input costs and a move towards cost recovery. However, monetary policy does not have any direct influence on these price changes. Therefore, policy will not normally respond to them, except to the extent that they are expected to influence “free” prices, especially through second round effects.

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

Table 3.2: Administered Items

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

Source: Statistics Botswana

3.2 Recent economic developments in Botswana

GDP growth decelerates in the year to June 2019

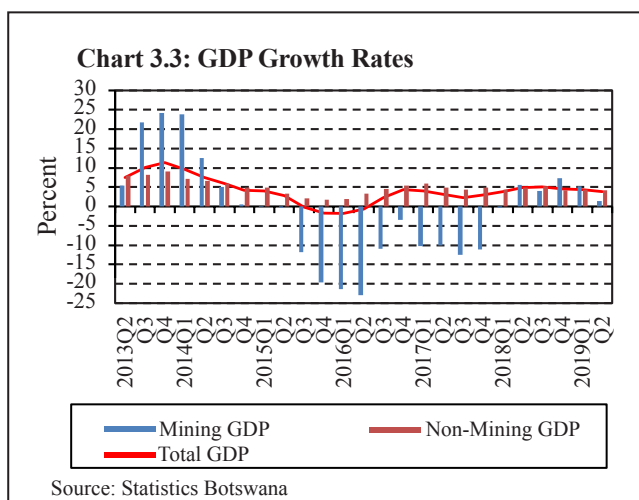
Real GDP grew by 3.9 percent in the twelve months to June 2019, compared to a faster expansion of 4.9 percent in the corresponding period in 2018 (Chart 3.3 and Table 3.3). The lower increase in output is mainly attributable to a deceleration in output growth of the mining sector. Growth in non-mining GDP also slowed in the review period. Mining output grew by 1.4 percent in the year to June 2019, compared to an increase of 5.6 percent in the corresponding period in 2018. The lower increase was attributable to a significant reduction in growth of the diamond industry output from 11.8 percent to 1 percent in the review period. The decrease in diamond output is mainly due to the decline in production by Orapa Mine, following a planned plant shutdown in April 2019. The expansion of output for soda ash (9.2 percent), other mining (3.9 percent) and prospecting (2.5 percent) partially offset the decline in growth of the diamond sector, thus contributing to the modest increase in output growth of the mining sector. Meanwhile, other mining sub-sectors contracted in the period under review, notably copper which declined by 32.2 percent as a result of the cessation of production at the Mowana Mine².

Non-mining GDP grew by 4.2 percent in the 12-month period to June 2019, compared to 4.8 percent in the corresponding period ending in June 2018. The lower growth in non-mining GDP was largely due to a slower growth of the trade, hotels and restaurants sector, mainly because of weak performance in the downstream diamond industries. However, faster expansion of the transport and communications (6.1 percent) and finance and business services (5.3 percent) boosted overall growth of the non-mining sectors.

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

	2018Q2	2019Q2
Total GDP	4.9	3.9
<i>By Sector</i>		
Mining	5.6	1.4
Non-Mining	4.8	4.2
Agriculture	2.7	1.9
Manufacturing	4.0	3.4
Water and Electricity	38.9	7.1
Construction	3.6	3.2
Trade, Hotels and Restaurants	6.0	4.4
Transport and Communications	5.2	6.1
Finance and Business Services	4.4	5.3
General Government	2.4	3.5
Social and Personal Services	3.2	3.5
<i>By Expenditure</i>		
Government Final Consumption	2.3	3.7
Household Final Consumption	7.3	2.4
Gross Fixed Capital Formation	1.1	5.9
Exports	-3.2	2.2
Imports	1.7	8.4

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 Mine³, which decreased by 23.3 percent in the second

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 Orapa output comprises production from Orapa, Damtshaa and Letlhakane mines.

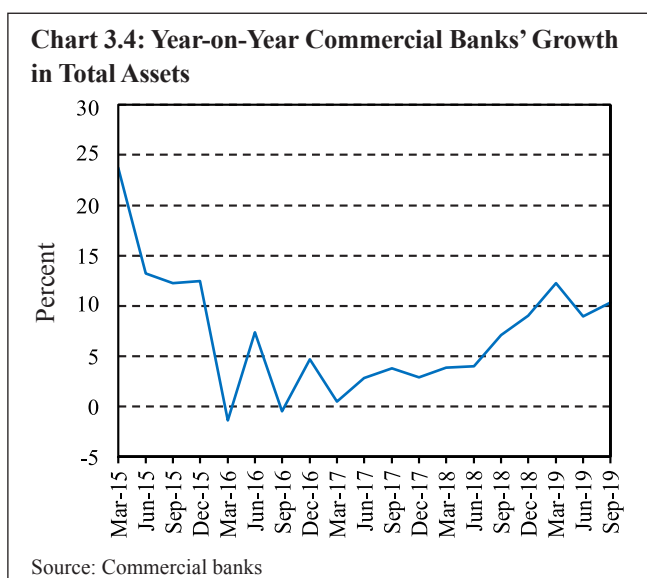
quarter, following a planned plant shut down in April 2019. Production at Jwaneng Mine increased by 6.5 percent in the same period.

Lucara Diamond Corporation (Karowe Mine) increased production by 34.1 percent to 109 312 carats⁴ 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 stones⁵ (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, compared to 366 086 carats recovered in 2018.

3.3 Monetary developments

Growth in banking sector assets accelerates in September 2019

Annual growth in banking sector assets accelerated from 7.2 percent in the twelve months to September 2018 to 10.7 percent in the corresponding period in 2019 (Chart 3.4). All the major assets, including loans and advances, which account for the largest proportion of commercial banks' assets (62.5 percent), balances held in foreign banks, holding of debt securities and outstanding Bank of Botswana certificates contributed to the overall increase.



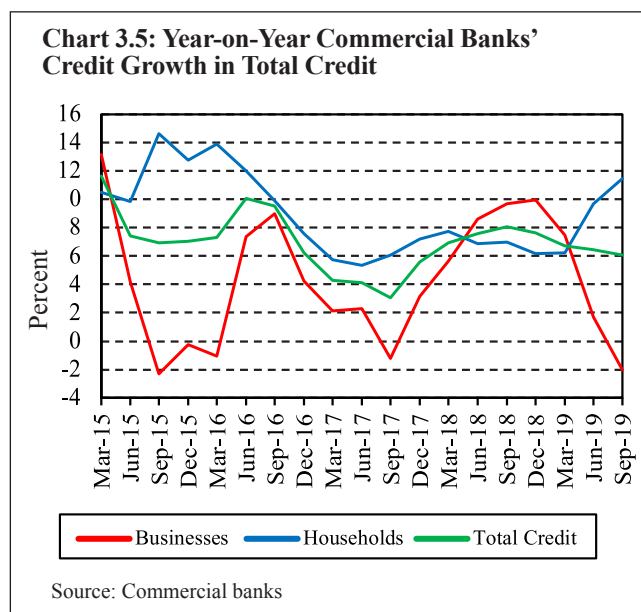
⁴ This includes 8 172 carats recovered from the re-processing of tailings from previous milling.

⁵ This includes the largest diamond ever recovered at Karowe Mine in April 2019 (Sewelô), weighing 1 758 carats.

Credit growth decelerates in September 2019

Year on year growth in commercial bank credit eased to 6.1 percent in the twelve months to September 2019, from 8.1 percent in the corresponding period in 2018 (Chart 3.5). The deceleration in growth in commercial bank credit is wholly attributable to reduced borrowing by businesses. Lending to the business sector contracted as a result of decreased utilisation of existing overdraft credit facilities in the year to September 2019, loan repayments by some companies in manufacturing, finance and trade industries. There were also base effects associated with higher credit growth in the second half of 2018. Meanwhile, utilisation of credit facilities by parastatals, albeit lower, increased in the year to September 2019.

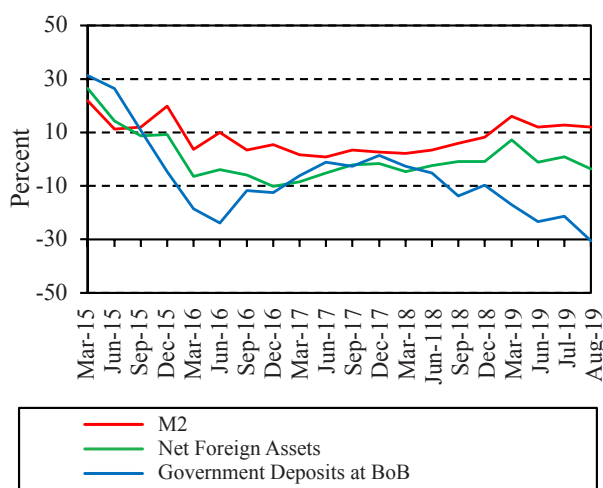
Conversely, household loans increased significantly, particularly unsecured lending, influenced by the recent increase in public services salaries. Furthermore, availability of bank funding/liquidity, indicated by growth in customer deposits, allowed banks to meet the rise in demand for credit.



Money supply growth accelerates in August 2019

Annual growth in money supply (M2) accelerated to 12.1 percent in the twelve months to August 2019 from 3.5 percent in the corresponding period in 2018 (Chart 3.6). This was due to the increase in credit to the private and parastatal sectors and the decline in government deposits at Bank of Botswana to fund government operations.

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



Source: Commercial banks and Bank of Botswana

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

The 3-month BoBC stop-out yield increased from 1.55 percent in the third quarter of 2018 to 1.73 percent in the corresponding period in 2019. Meanwhile, the real interest rate for the 3-month BoBC increased from -1.41 percent in the third quarter of 2018 to -1.14 percent in the corresponding period in 2019, reflecting both the decrease in the average inflation rate as well as the increase in the nominal yield.

In September 2019, the stop out yields for the 7-day BoBC⁶ and 3-month BoBC were 1.41 percent and 1.73 percent, respectively.⁷ Meanwhile, the real rate of interest for the 7-day BoBC decreased from -1.23 percent in August to -1.54 percent in September 2019, reflecting the higher inflation and lower nominal yield. Similarly, the real 3-month BoBC yield decreased from -1.14 percent to -1.23 percent in the same period, reflecting the higher inflation in September 2019. Box 2 discusses reforms to monetary operations.

⁶ 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.

Credit ratings affirmed

S&P Global affirmed Botswana’s sovereign credit rating in October 2019 at A2 and ‘A-/A-2’, respectively, for long and short-term bonds in domestic and foreign currency, maintaining the stable economic outlook. Moody’s Investors Service released a review on Botswana’s ratings in September 2019, but did not announce a credit rating action. The ratings are supported by the strong external and fiscal balance sheets, a well-managed economy and low public debt, as well as the country’s robust public institutions. However, the ratings could be revised downwards if the fiscal and external positions were to deteriorate considerably, either due to underperformance in the diamond sector, hence a weaker economic growth, or a more-than-anticipated increase in fiscal spending. In general, the ratings are constrained by the country’s narrow economic base, which relies heavily on the diamond sector, despite efforts to enhance private sector participation and diversify the economy.

⁷ Following the reduction in the Bank Rate in August 2019, the 3-month BoBC was auctioned in October 2019. The September 2019 yield is carried over from the August auction, which was before the rate cut. Hence, the impact of the rate cut is only reflected in the October 2019 auction.

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 particular, on April 30, 2019, the Bank introduced the 7-day BoBC as the main instrument for conducting monetary operations to replace the 14-day paper. As expected, the move has improved liquidity management by both the Bank and the commercial banks.

In addition, on October 9, 2019, the Bank implemented “reserves averaging” in the determination of the Primary Reserve Requirement (PRR). Under “reserves averaging”, commercial banks do not have to meet the PRR daily but, rather, fulfil this requirement on an average basis over the maintenance period. The maintenance period has been adjusted from a calendar month to the period covering all days from the beginning of the second Wednesday of each month to the end of the Tuesday preceding the second Wednesday of the following (succeeding) month”. This will result in either a four- or five-week maintenance period that, over time, remains closely aligned to the calendar month. The adjustment allows the start date to avoid the maintenance period ending at the end of the week, during a weekend or on a public holiday, thus further reducing precautionary savings; and the 7-day BoBC issuance cycle to be aligned with the maintenance period, with less need for fine-tuning operations through reverse repos.

Consultations with external stakeholders on possible changes to the policy rate and interest rate corridor have been completed and the resultant feedback will, together with lessons from other jurisdictions, be useful in informing the final decisions.

3.4 Asset markets

Property market remains weak in the first quarter of 2019

According to the latest Riberry Report⁸ (first quarter of 2019), the residential rental market weakened in the first quarter of 2019 compared to the previous quarter, reflecting a decrease in rentals for upper-end properties and weaker demand for middle-end properties. However, the rental market enjoys good demand and supply for properties in the lower-end and medium cost properties 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. Looking ahead, the demand for lower-end prime located residential housing is expected to improve further given affordability of properties in this category relative to others (middle and upper-end).

The market for office space remains weak due to increasing supply from completed construction developments, such as the Botswana Unified Revenue Service building at the Gaborone Central Business District (CBD). Despite the general weak demand for office space, there has been reasonable take-up of office space at the CBD by Government, a major office space occupier, as well as by some corporates. However, for 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.⁹ Meanwhile, the demand for retail space remains fair across all market segments, with proposed large shopping centres in the CBD and Block 10 (Gaborone) and Mogoditshane. In addition, other centres with good demand for retail space are Maun, Francistown, Mahalapye and Palapye. With regard to industrial property, the supply of bigger warehouse space has decreased, while the demand has improved.¹⁰ Meanwhile, the supply for prime location industrial space is expected to improve, going forward, given ongoing industrial construction in places such as Nkoyaphiri Industrial Area and Tlokweng (along the Tlokweng Border Road).

Stock market index declines

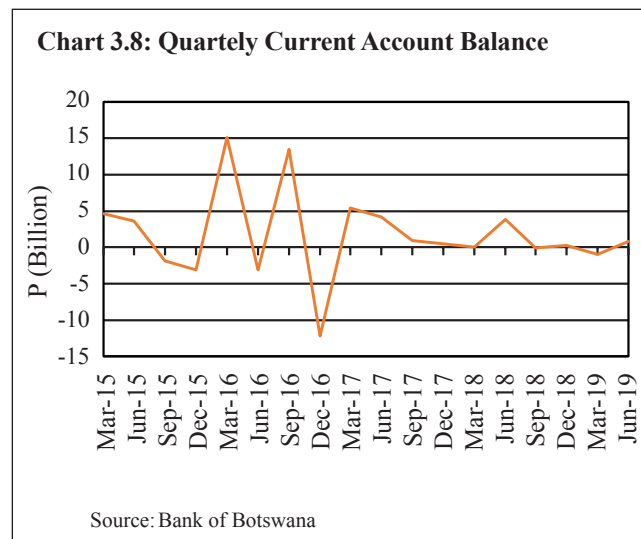
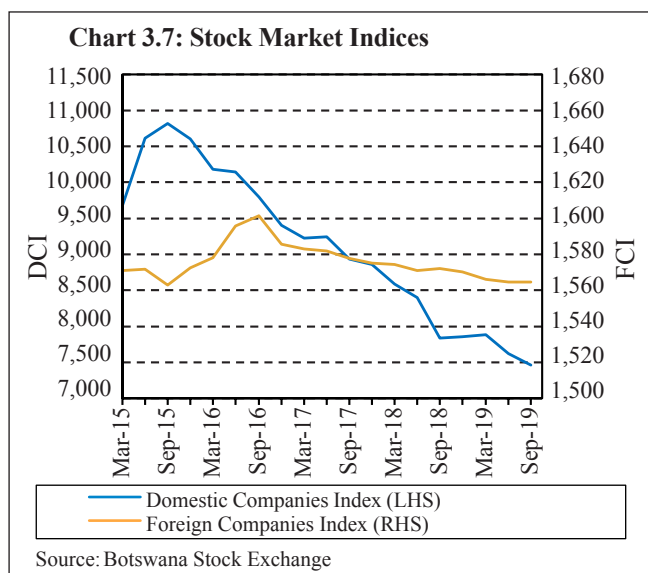
The Domestic Companies Index (DCI) declined by 4.8 percent in the twelve months to September 2019 compared to a reduction of 12.2 percent in the year to September 2018 (Chart 3.7). The decline was mainly due to the lower share prices for Stanchart and Letshego, which fell by 58.3 percent and 53.6 percent, respectively, in the same period. According to Botswana Stock Exchange, the continuous decline in the DCI was reflective of the low trading activity and liquidity as well as sluggish corporate earnings due to a restrained economic environment.

The Foreign Companies Index (FCI) declined by 0.5 percent in the year to September 2019, following a 0.4 percent decrease in the 12 months to September 2018 (Chart 3.7). This was largely attributed to the year-on-year decrease in share price for Tlou (-48.7 percent) and Lucara (-22.1 percent).

⁸ This is a quarterly report produced by independent valuers, Riberry Botswana (Pty) Ltd.

⁹ Prime rentals are about P100/m². However, rentals in secondary areas such as Gaborone International Finance Park (also known as Kgale Mews), situated at the foot of Kgale Hill adjacent to Game City cost P75/m² while prime industrial areas like Gaborone International Commerce Park cost P65/m².

¹⁰ Investors prefer bigger warehouses, but available warehouse space is limited.



3.5 Balance of payments

The current account records a surplus in the second quarter of 2019

The current account recorded a surplus of P846 million in the second quarter of 2019, compared to P3.8 billion for the corresponding period in 2018 (Chart 3.8). This was due to the smaller surplus in the merchandise trade balance caused by the P2.2 billion increase in imports and the P1.4 billion reduction in exports.

The diamond exports, which accounted for 92 percent of total exports of goods, fell from P17.3 billion in the second quarter of 2018, to P16.1 billion during the corresponding period in 2019. In the same period, diamond imports increased from P4.6 billion to P5.5 billion. The increase in diamond imports is associated with diamonds aggregation activities, which includes the importation and re-exportation of diamonds.

The other major contributing commodities to the increase in imports are machinery and electrical equipment, metal and metal products and vehicles and transport equipment categories. The importation of these capital goods and material is associated with the ongoing implementation of the Cut 9 project in Jwaneng and construction of Mohembo and Kazungula bridges. In addition, the growth in consumer demand, mainly grey imports for cars and electrical/electronic devices contributed to the increase in imports.

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, which was larger than receipts by locals from their investments abroad.

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

The overall financial account had an estimated net outflow of P3 billion during the second quarter of 2019 compared to P6.8 billion in the second quarter of 2018. The reduced outflow is attributable to, among others, smaller deposits abroad.

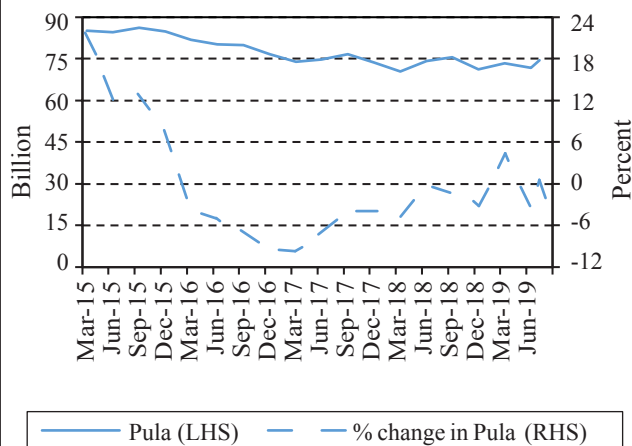
The overall balance of payments was in deficit of P2.7 billion in the second quarter of 2019, compared to a deficit of P972 million for the corresponding period in 2018. The deficit was due to, inter alia, foreign exchange outflows to fulfill government financial obligations, including external loan servicing and imports.

Foreign exchange reserves decrease

As at the end of August 2019, foreign exchange reserves amounted to P73.4 billion, a decrease of 5 percent from P77.3 billion in August 2018 (Chart 3.9). The decrease was mainly a result of drawdown to pay for government obligations.

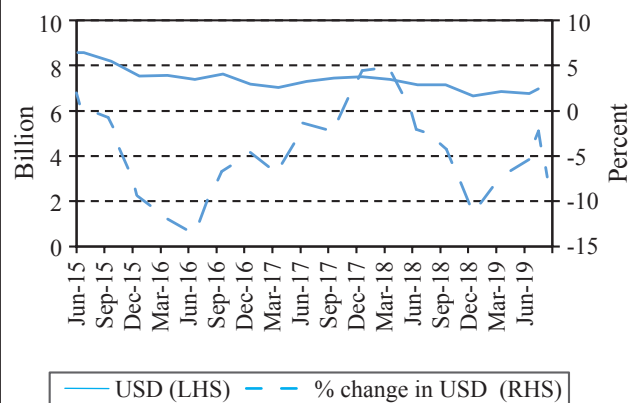
In foreign currency terms, the level of reserves decreased by 8.3 percent from USD7.2 billion in August 2018 to USD6.6 billion in August 2019 (Chart 3.10). The reserves also decreased by 3.9 percent from SDR5.1 billion to SDR4.9 billion over the same period. The level of reserves as at the end of August 2019 was equivalent to 15.1 months of import cover of goods and services compared to 15.9 months in August 2018.

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

An upward annual rate of crawl of 0.3 percent is being implemented in 2019 following a 0.3 percent downward rate of crawl implemented in 2018. Meanwhile, the weights of the Pula basket are 45 percent South African rand and 55 percent SDR. The upward rate of crawl seeks to maintain the stability of the REER as domestic inflation was (at the beginning of 2019) 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.

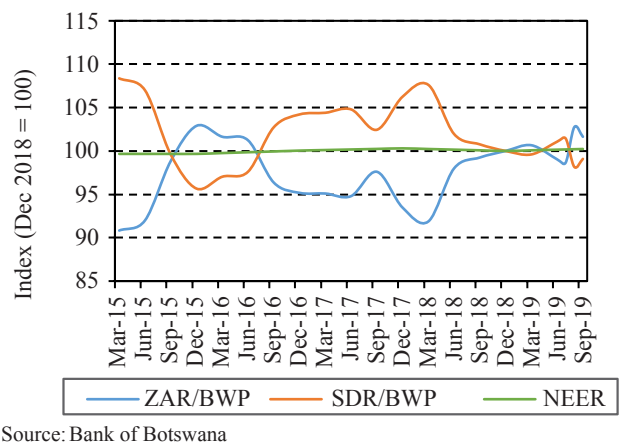
Bilaterally, the Pula appreciated by 2.4 percent against the South African rand and depreciated by 1.7 percent against the SDR in the twelve months to September 2019 (Chart 3.11). Against the SDR constituent currencies, the Pula depreciated by 8.9 percent against the Japanese yen, 4 percent against

the US dollar and 0.6 percent against the Chinese renminbi, while it appreciated by 2.3 percent against the euro and 1.8 percent against the British pound.

The movement of the Pula against the SDR constituent currencies largely reflects the performance of the South African rand against the SDR currencies. Notably, in the same review period, the rand depreciated by 4 percent against the SDR. Against the SDR constituent currencies, the rand depreciated by 11 percent against the Japanese yen, 6.3 percent against the US dollar, 2.9 percent against the Chinese renminbi, 0.6 percent against the British pound and 0.1 percent against the euro.

The South African rand depreciated along with other emerging market currencies, mainly weighed down by capital outflows due to international factors. Emerging markets currencies, including the South African rand, are generally exposed and subject to external vulnerabilities, including unfavourable investor sentiment and policy uncertainty. In this instance, global investor risk appetite was weakened by an attack on Saudi Arabian oil refining facilities, which affected global oil supplies leading to an increase in international oil prices, albeit short-lived. Furthermore, global risk appetite was dampened by the launch of a formal impeachment inquiry against the US President.

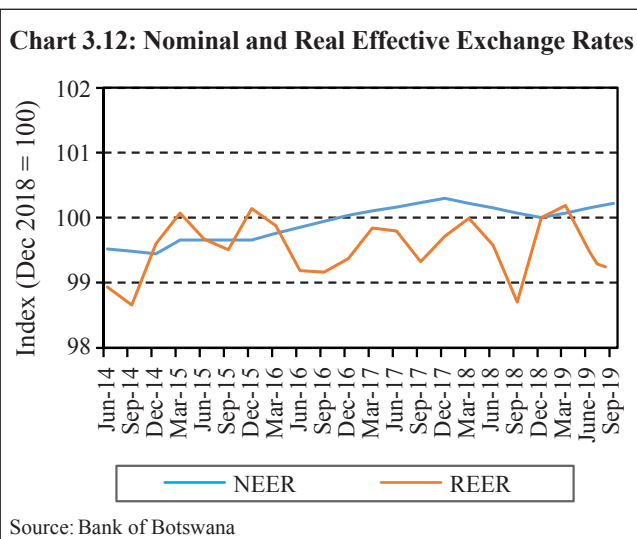
Chart 3.11: Nominal Exchange Rate Indices



Source: Bank of Botswana

NEER appreciated in September 2019

The NEER of the Pula appreciated by 0.1 percent in the twelve months to September 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 August 2019

The REER appreciated by 0.3 percent in the twelve months to August 2019 (Chart 3.12), due to a slightly higher inflation in Botswana (2.9 percent) than in trading partners (2.8 percent) and the slight appreciation of the NEER. 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 appreciated by 0.7 percent against the SDR. Regarding the SDR constituent currencies, the Pula appreciated by 4.9 percent against the British pound, 4.5 percent against the euro and 1.5 percent against the Chinese renminbi, while it depreciated by 4.7 percent against the Japanese yen and 1.9 percent against the US dollar.

3.7 Recent global economic developments

Global growth modest

According to the October 2019 World Economic Outlook (WEO), global output growth for 2019 is projected at 3 percent, lower than the 3.6 percent estimate for 2018 (Table 3.4) and the slowest pace since the 2008 financial crisis. Growth in the first nine months of 2019 was adversely affected by the heightened trade tension between the US and China, slowdown in manufacturing and global trade, as well as structural factors such as low productivity growth and aging populations in advanced 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 percent in the second quarter, but was higher than the earlier forecast of 1.8 percent for the quarter. The slowdown in growth was mainly influenced by the decline in both private

inventory investment (the difference between production and sales) and exports, affected by the trade war between the US and China. The impact of the decline was, however, 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.

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 due to lower manufacturing output, which also involved a shut down by car manufacturers, as well as the usage of the earlier accumulated stockpiles as part of the Brexit contingency plan.

Emerging markets' growth moderates

For emerging market economies, output growth softened, primarily due to heightening trade tensions, tightening financial conditions, 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 year-on-year by 5 percent in the second quarter of 2019, slowing from a 5.8 percent expansion in the prior period and was below market expectation of 5.7 percent. It was the weakest growth rate since the first quarter of 2013. Slower growth in the manufacturing, construction and mining sectors contributed to the overall slowdown of the economy.

South African GDP recovers

Regionally, output in South Africa expanded by 3.1 percent year-on-year in the second quarter of 2019, following a decrease of 3.1 percent in the first quarter of 2019. Mining, finance, trade and government services were the main drivers of growth. Mining expanded by 14.4 percent, the largest increase

since the second quarter of 2016, when production jumped by 16.3 percent, buoyed by higher output of iron ore, manganese and coal.

Global commodity prices

Diamond prices decrease

The global rough diamond price index decreased by 2.8 percent from 147 in the second quarter of 2019 to 142.9 in the third 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 0.96 percent from 214.4 in the second quarter of 2019 to 212.4 in the third quarter. This was due to the weaker demand for diamond jewellery and liquidity constraints forcing retailers to sell at a discount, in order to raise funds for bank loan repayments. In addition, the recent street protests in Hong Kong have dented sales of luxury goods, including diamond jewellery.

Table 3.4: Growth Estimates and Projections

	Estimate		Projection	
	2017	2018	2019	2020
Global	3.8	3.6	3.0	3.4
Advanced economies	2.5	2.3	1.7	1.7
USA	2.4	2.9	2.4	2.1
Euro area	2.5	1.9	1.2	1.4
UK	1.8	1.4	1.2	1.4
Japan	1.9	0.8	0.9	0.5
EMDEs	4.8	4.5	3.9	4.6
China	6.8	6.6	6.1	5.8
Brazil	1.1	1.1	0.9	2.0
India	7.2	6.8	6.1	7.0
Russia	1.6	2.3	1.1	1.9
South Africa	1.4	0.8	0.7	1.1
Botswana	2.4	4.5	4.3	4.6

Source: IMF WEO October 2019 and Draft 2020 Budget Strategy Paper for Botswana

Note: EMDEs stands for emerging market and developing economies.

Oil prices decreased in the third quarter of 2019

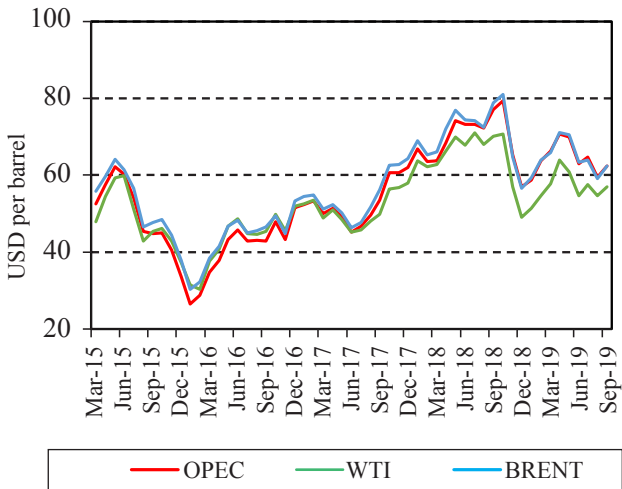
International oil prices (Brent crude and OPEC) averaged slightly above USD60 per barrel in the third quarter of 2019, lower than USD65 per barrel in the second quarter of 2019 (Chart 3.13). The OPEC reference crude oil basket price and the Brent crude fell by 8.4 percent and 9.5 percent, averaging USD62.19 per barrel and USD61.84 per barrel, respectively, in the third quarter of 2019 compared to USD67.89 per barrel and USD68.34 per barrel in the second quarter of 2019. The price of the West Texas Intermediate (WTI)¹¹ also fell by 5.7 percent from an average of USD59.80 per barrel in the second quarter of 2019 to an average of USD56.40 per barrel in the third quarter. The decrease in international oil prices reflects prospects of continued trade war between the US and China, which has resulted in lower global economic growth, thereby affecting the demand for oil.

However, in September 2019, international oil prices increased, due to lower than expected US crude oil inventories and continued geopolitical tensions in the Middle East¹². Nevertheless, oil prices have since fallen, as Saudi Arabia indicated that half the production lost in the drone attacks had already been restored. Overall, developments in the international oil market imply marginal downward pressure on Botswana inflation.

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

¹² On September 14, 2019, there was a drone attack on Saudi Arabia's crude oil facilities, which was expected to reduce the world's daily oil production by 5 percent.

Chart 3.13: Oil Prices (Monthly Averages)

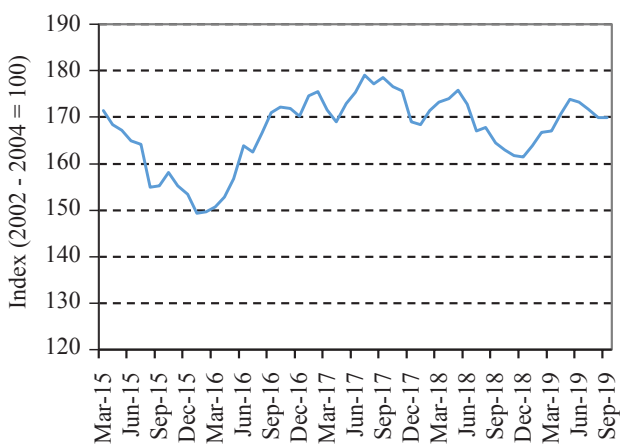


Source: OPEC and US Energy Information Administration

Food prices increased in the third quarter of 2019

According to the United Nations Food and Agriculture Organisation (FAO), the global food price index averaged 170.5 points in the third quarter of 2019, a 3.7 percent increase from an average of 164.5 points in the corresponding period in 2018. The increase in prices was attributable to higher sugar and meat prices. The food price index averaged 169.9 points in September 2019, unchanged from August 2019 but 3.3 percent higher than in the corresponding period last year (Chart 3.14).

Chart 3.14: Food Price Index



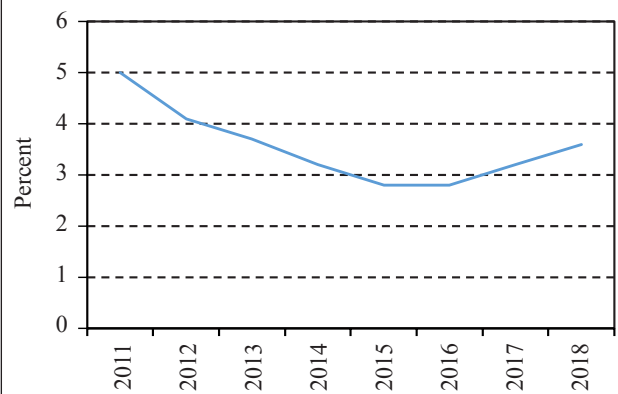
Source: Food and Agriculture Organisation

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 4.1 percent in September 2019, remaining within the South African Reserve Bank (SARB)'s target range of 3-6 percent.

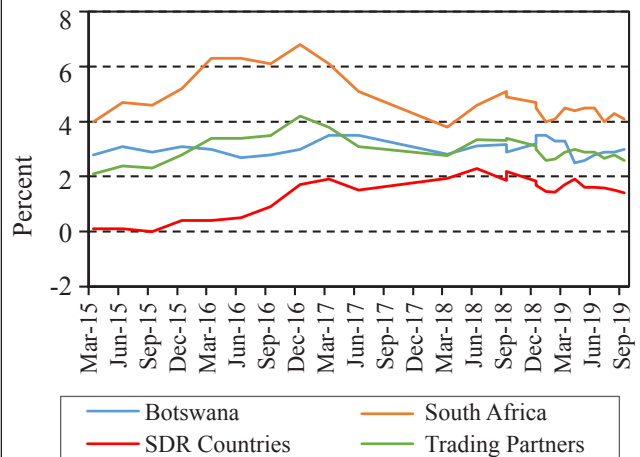
Chart 3.15: Global Inflation



Source: Bloomberg

The average trade-weighted inflation for Botswana's trading partners decreased from 2.8 percent in August to 2.6 percent in September 2019 (Chart 3.16).

Chart 3.16: Botswana Inflation and International Inflation



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

Mixed monetary policy developments

In the most recent policy decisions in advanced economies (Table 3.5), the European Central Bank (ECB) maintained the deposit rate, refinancing rate and lending rate at -0.50 percent, zero percent and 0.25 percent, respectively, reiterating the need for a highly accommodative monetary policy stance for a prolonged period of time to support underlying inflation pressures and headline inflation developments over the medium term. In addition, the ECB indicated that it will resume asset purchases at a pace of 20 billion euros per month, effective November 1, 2019. Moreover, it will adjust the new series of quarterly targeted longer-term refinancing operations (TLTRO)¹³ to preserve favourable bank lending conditions and smooth transmission of monetary policy.

The range for the US Federal Funds Rate was reduced by 25 basis points to 1.50-1.75 percent in October 2019, as inflation remains subdued amid weak business fixed investment and exports. Meanwhile, Bank of England (BoE) maintained the policy rate at 0.75 percent at the September 2019 meeting, projecting that the UK would avoid falling into recession in 2019. Nevertheless, uncertainty pertaining to Brexit and trade tensions continued to weigh down on the economy. The Bank of Japan (BoJ) also maintained its asset purchases and low policy rate in October 2019.

In emerging market economies, the Reserve Bank of India reduced the policy rate by 25 basis points to 5.15 percent in October 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 the key rate by 50 basis points to 6.5 percent in October 2019, as short-term risks to the inflation outlook continued to moderate and the economic outlook deteriorated. The Bank of Brazil also cut the policy rate by 50 basis points to 5 percent in October 2019, in the context of a low inflation, weak economic activity, a decelerating global economy and deterioration of the outlook for emerging economies. Meanwhile, the South

African Reserve Bank (SARB) maintained the repo rate at 6.5 percent in September 2019, assessing that risks to the inflation outlook were largely balanced.

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. The LPR was lowered further by 5 basis points to 4.20 percent in September 2019. The reduction followed a 50 basis points cut on the reserve requirements to support the economy.

Table 3.5: Monetary Policy Decisions

Central Bank	Latest Meeting	Current Policy Rate (Percent)	Change from Previous Meeting
Bank of Botswana	October 2019	4.75	No change
SARB	September 2019	6.50	No change
US Federal Reserve	October 2019	1.50 – 1.75	Decreased by 0.25 percent
BoE	September 2019	0.75	No change
ECB	October 2019	0.00	No change
BoJ	October 2019	-0.10	No change
PBoC	September 2019	4.35	No change
Brazil	October 2019	5.00	Decreased by 0.50 percent
India	October 2019	5.15	Decreased by 0.25 percent
Russia	October 2019	6.50	Decreased by 0.50 percent

¹³ These are loans that the ECB provides to banks at low interest rates to ease credit conditions and stimulate bank lending. The interest rate in each operation would be set at the level of the average rate applied in the Eurosystem's main refinancing operations over the life of the respective TLTRO. Moreover, the maturity of the operations would be extended from two to three years.

4. THE ECONOMIC AND POLICY OUTLOOK

4.1 Global economic prospects

The global economic outlook has been revised downwards, on account of rising trade barriers, macroeconomic strain in several emerging market economies, as well as structural factors such as low productivity growth and aging populations in advanced economies. Growth in advanced economies has been revised downwards, reflecting the slowdown of growth in the US on account of ongoing trade tensions between the US and China. Meanwhile, in South Africa, the growth outlook is projected to remain subdued due to a larger than anticipated negative impact of intensifying 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 October 2019 WEO, global output growth is forecast at 3 percent and 3.4 percent in 2019 and 2020, respectively, from an estimated expansion of 3.6 percent in 2018. The growth forecasts have been revised downwards by 0.2 percentage points and 0.1 percentage points for 2019 and 2020, respectively, from the July 2019 WEO Update projections. The revisions take into account the heightened trade tensions between the US and China, macroeconomic strain in several emerging market economies, as well as structural factors such as low productivity growth and aging populations in advanced economies. 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 1.7 percent in both 2019 and 2020, compared to 2.3 percent in 2018. The 2019 projection is 0.2 percentage points lower than the July 2019 WEO Update projection, mainly reflecting the heightened trade disputes between the US and China. Overall, risks to global output expansion are skewed to the downside. They include rising trade barriers, tighter financial conditions and heightened geopolitical tensions including Brexit-related risks.

UK economic prospects worsen slightly for 2019

The UK economy is expected to grow by 1.2 percent in 2019 and by 1.4 percent in 2020 compared to 1.4 percent in 2018. The forecast for 2019 is 0.1 percentage points lower relative to the July 2019 WEO Update, reflecting the negative impact from ongoing Brexit uncertainty. Meanwhile, the European Union has agreed to extend Brexit until January 31, 2020.

Output growth for US to moderate

For the US, output is forecast to grow by 2.4 percent in 2019 before moderating to 2.1 percent in 2020, as stimulus from the recently adopted two-year budget deal offsets the fading effects of the 2017 Tax Cuts and Jobs Act. However, the growth forecasts are 0.2 percentage points lower for 2019, but 0.2 percentage points higher for 2020, relative to the July 2019 WEO Update.

Growth for the euro area set to moderate

In the euro area, economic expansion is projected to ease from 1.9 percent in 2018 to 1.2 percent in 2019 (0.1 percentage points lower than in the July 2019 WEO Update), before increasing to 1.4 percent in 2020. The 2019 growth forecasts for Germany and France have been revised downwards due to weaker-than-expected external demand in the first half of 2019. The euro area growth is anticipated to improve in 2020 due to the expected recovery in external demand.

Emerging markets GDP expansion projected to be lower

Growth in economic activity in emerging market and developing economies is projected at 3.9 percent and 4.6 percent for 2019 and 2020, respectively, from an estimated expansion of 4.5 percent in 2018. The forecasts have been revised downwards by 0.2 percentage points and 0.1 percentage points for 2019 and 2020, respectively, compared to the July 2019 WEO Update projections. The revisions are influenced by lower economic performance in most major regions, largely reflecting the effects of heightened 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 points and 0.2 percentage points for 2019 and 2020, respectively, relative to the July 2019 WEO Update projections. In India, the downward revisions of 0.9 percentage points and 0.2 percentage points for 2019 and 2020, respectively, reflect the weaker outlook for growth in domestic demand than previously envisaged.

Growth in the South African economy to remain subdued

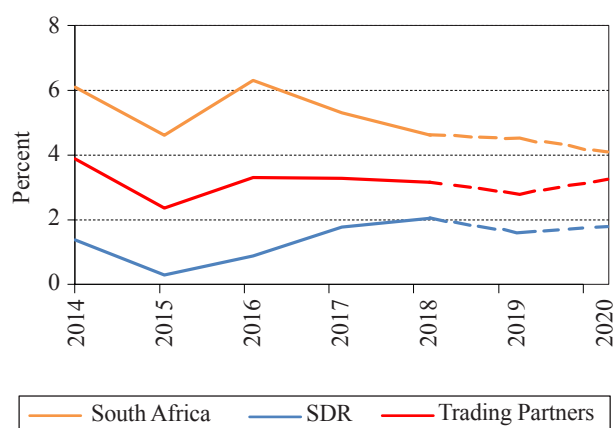
Growth prospects in South Africa are expected to remain subdued, generally constrained by protracted electricity supply constraints and sluggish demand as a result of weaker business confidence. Output is expected to grow by 0.7 percent and 1.1 percent in 2019 and 2020, respectively, compared to 0.8 percent in 2018. The mining and manufacturing industries are expected to be severely affected as the major consumers of electricity.

Meanwhile, the SARB maintained the forecast for GDP growth for 2019 at 0.6 percent, while the forecast for 2020 was revised downwards from 1.8 percent to 1.5 percent due to downward revisions to global growth and domestic potential growth.

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 4.2 percent in 2019, a downward revision by 0.2 percentage points from the previous forecast, mainly reflecting a stronger exchange rate, as well as subdued domestic and global inflation pressures. Overall, it is forecast that inflation will remain 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

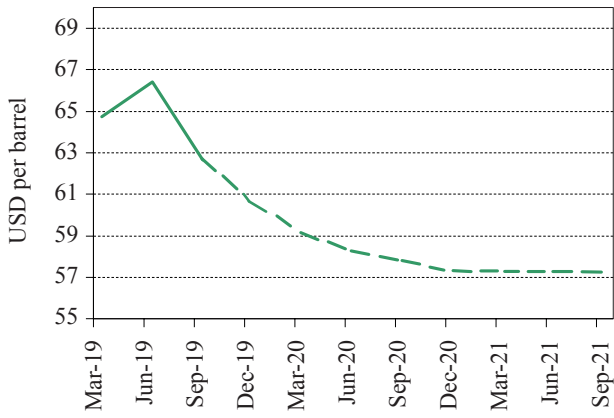
Diamond prices expected to fall

Global rough diamond prices are expected to trend downward in the fourth quarter of 2019 against the background of weaker global demand and generally slower pace of economic activity. Likewise, polished diamond prices as well as diamond jewellery prices are expected to fall in the final quarter 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 fourth quarter of 2019 (Chart 4.2), influenced by the global economic slowdown. International oil prices are expected to remain below USD60 per barrel. Meanwhile, the extended agreement among oil producers to cut production by 1.2 million barrels per day 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.

Chart 4.2: International Oil Prices

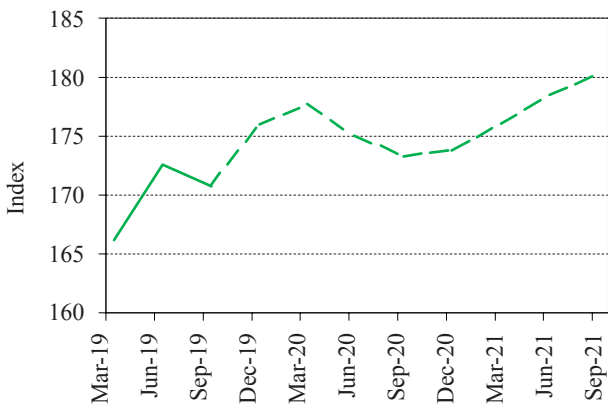


Source: Bloomberg

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, food prices are expected to also increase due to anticipated lower crop production resulting from lower rainfall, pests and the El Nino weather condition expected in the latter part of 2019. The cyclones in Southern Africa that occurred in the first half of 2019, 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 an upward pressure on food prices. Overall, there is potential modest upward pressure from food prices on domestic inflation.

Chart 4.3: International Food Prices FAO Index



Source: Bloomberg

4.2 Outlook for domestic economic activity

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 moderate, but lower than potential, domestic output growth in the short to medium term. Meanwhile, the global economy is projected to slow down, which could negatively affect the diamond market.

Positive growth expected in domestic output

Projections from the Draft¹⁴ 2020 Budget Strategy Paper indicate that domestic economic activity will expand by 4.3 percent and 4.6 percent in 2019 and 2020, respectively. It is anticipated that growth will be led by the non-mining sector, in particular, the services sectors including trade, hotels and restaurants, transport and communications and finance and business services. In addition, ongoing structural reforms such as improving the ease of doing business, and concerted efforts channelled towards the transformation of the economy from a resource-based to a knowledge-based economy should provide impetus to economic activity going forward.

Furthermore, prospects for the non-mining sectors are supported by, among others, the prevailing accommodative monetary conditions, the expected growth in government expenditure in the 2019/20 fiscal year, as well as improvements in electricity generation and water reticulation. However, 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 September 2019 Business Expectations Survey results suggest that firms are less optimistic about business conditions compared to the June 2019 Survey.

¹⁴ The projections are subject to change after incorporating relevant inputs such as comments from the Budget Pitso and the October 2019 World Economic Outlook.

4.3 Monetary policy and the inflation outlook

Inflation is forecast to remain below the lower bound of the Bank's 3 - 6 percent objective range for the remainder of 2019 and the first quarter of 2020.¹⁵ However, inflation is expected to revert to within the objective range in the second quarter of 2020. Compared to the August 2019 forecast, inflation is projected to be lower in the short-to-medium term, in the absence of a forecast-increase in domestic fuel prices in the fourth quarter of 2019 and first quarter of 2020. Upside risks to the inflation outlook relate to any unanticipated substantial upward adjustment in administered prices and government levies and/or taxes, as well as the potential increase in international commodity prices beyond current forecasts. These risks are moderated by prospects of weak global economic activity and continuance of modest domestic economic growth.

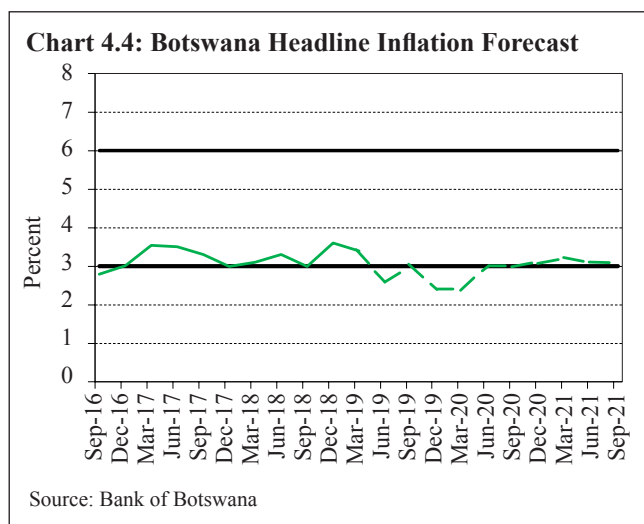
Inflation projected to be within the objective range in the medium term

Headline inflation is projected to remain below the lower bound of the Bank's medium-term objective range for the remainder of 2019 and the first quarter of 2020 but to revert to within the objective range in the second quarter of 2020 (Chart 4.4).

Inflation is expected to remain subdued in the fourth quarter of 2019, due to base effects associated with an increase in fuel prices in the corresponding period in 2018¹⁶. There is, however, a possibility of an increase in electricity and water tariffs in the second quarter of 2020, which are expected to contribute an estimated 0.53 percentage points to inflation. Consequently, inflation is expected to increase to within the objective range in the second quarter of 2020.

Additional upward pressures on the medium-term inflation outlook, although not substantial, emanate from the expected improvement in domestic economic activity, driven to some extent, by the already announced increase in public service salaries in the 2020/21 financial year.

Meanwhile, according to the September 2019 BES, the business community expect inflation to be within the objective range in both 2019 and 2020. Box 5 evaluates the performance of the Bank's inflation forecasting model.



¹⁵ Although inflation in September 2019 was 3 percent, it should be noted that the analysis here is based on the Bank's model, which is a quarterly model.

¹⁶ The increase in fuel prices added approximately 0.9 percentage points to headline inflation in the fourth quarter of 2018.

Box 3: Evaluation of the Performance of the Bank’s Inflation Forecasting Model

The Bank uses a forecast-based forward-looking monetary policy framework that is guided by a forecasting and policy analysis system (FPAS). The Core-Model, which forms part of the FPAS, is the main instrument for producing the Bank’s quarterly inflation forecasts, which are used as input in policy deliberations during MPC meetings. It provides a reliable outlook of future economic developments and possible policy actions necessary to achieve the Bank’s medium-term inflation objective of 3 – 6 percent. It is, thus, crucial for the formulation and implementation of monetary policy. In this context, the Bank remains committed to enhancing the forecasting ability of the Core-Model.

An assessment of the forecast performance of the Core-Model made for quarterly headline inflation forecasts between December 2008 and December 2018 indicates, as expected, that the Bank’s forecasting model performs well in the short term compared to the longer-term. The assessment was conducted by comparing the Bank’s inflation projections against actual outcomes. The good performance of the model in projecting short-term inflation movements reflects to some extent, reliable assumptions on short-term economic developments in contrast to highly uncertain assumptions regarding distant economic developments.

The model’s forecasting ability of short-term inflation has remained good and largely unchanged, especially for the first and second quarters of the forecast horizon (Chart 4.5). Meanwhile, for the periods further into the forecast horizon (four to eight quarters), the performance of the model has improved significantly over time. Several factors may account for this improvement, and these include: continuous updating of the model’s equations and parameters to reflect the prevailing structure of the economy; enhanced expertise and experience of Bank Staff; infusion of expert judgement into the predictions; the active participation and input in the forecasting process of the MPC members and sector specialists; as well as the impact of enhanced policy credibility on expectations and price formation.

Chart 4.5: Rolling Four-Year Sample of Forecast Errors using Mean Absolute Forecast Errors (2008 to 2018)

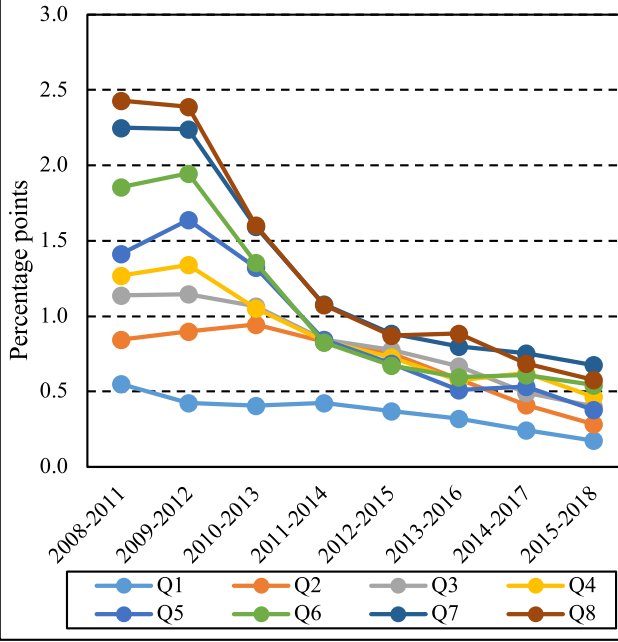
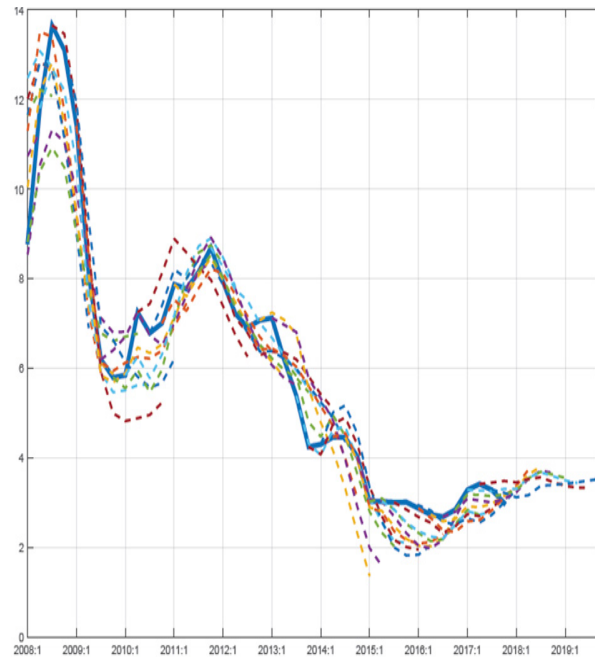


Chart 4.6: In-Sample Inflation Forecast Simulations (2008 to 2018)



Note: The solid line on Chart 4.6 represents actual inflation, while the dotted lines are inflation projection simulations.
 Source: Bank of Botswana Core-Model

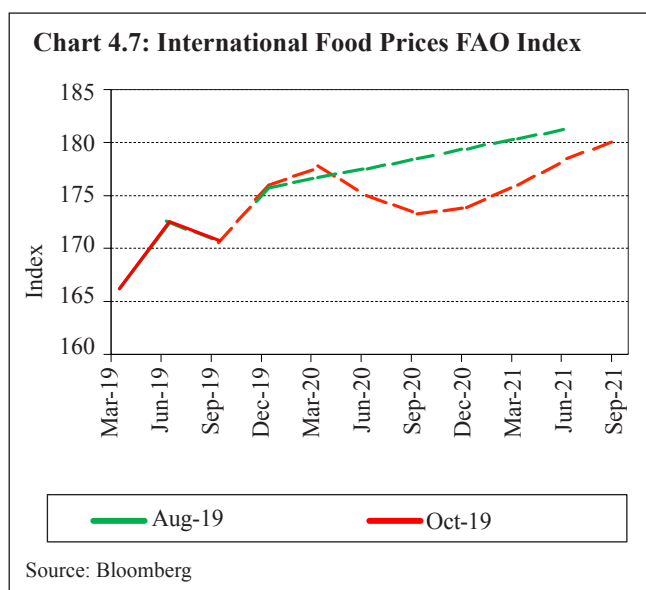
The in-sample inflation forecast simulations from the period of inception of the Bank’s forward-looking monetary policy framework in 2008 until the end of 2018, also indicates that the current structure of the Bank’s forecasting framework has a high predictive power (Chart 4.6).

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 anticipated upward adjustments in water and electricity tariffs in the second quarter of 2020. 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 decrease slightly in the medium term.

International food prices to increase

Compared to the August 2019 forecast, international food prices have been revised downwards in the medium term. (Chart 4.7). The downward revision in food prices in the medium term mainly reflects the prospects of reduced global trade volumes due to lower import demand for most of the food products.

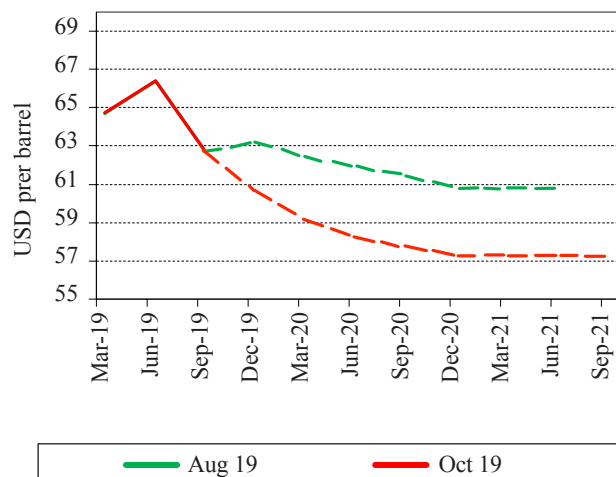


International oil prices revised downwards

Relative to the August 2019 projection, international oil prices have been revised downwards in the short to medium term (Chart 4.8). The downward revision mainly reflects the decrease in demand due to global economic slowdown, resulting from the protracted trade tensions between the US and China.

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

Chart 4.8: International Oil Prices



Source: Bloomberg

Inflation forecast revised downwards

The October 2019 inflation forecasts have been revised downwards from the August 2019 forecasts to reflect the downward revision in both international food and fuel prices as well as the downward revision of South African inflation in the short-term. Moreover, domestic fuel prices are no longer expected to increase in the last quarter of 2019 and the first quarter of 2020 as was previously anticipated.

Exchange rate movements

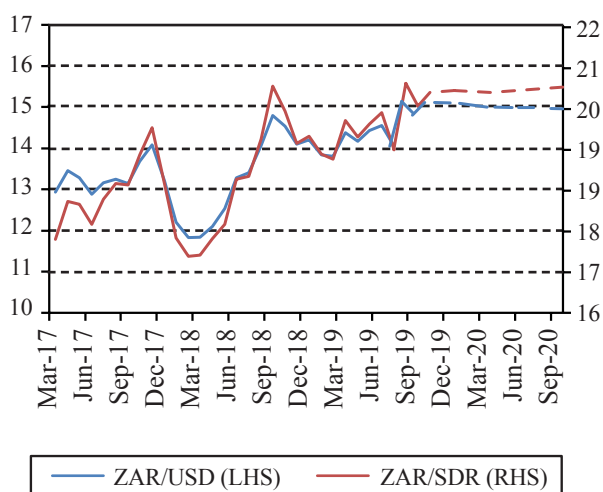
The Pula exchange rate is determined by the performance of the Pula basket currencies and the rate of crawl. Once the basket composition and the rate of crawl (based on inflation differentials) have been determined, the daily changes in the value of the Pula against other currencies are a result of movements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

The South African rand is expected to depreciate against major currencies in the next four quarters (Chart 4.9), as global factors are expected to weigh down investor sentiment for emerging market currencies. The trade war between US and China remains the dominant driver of sentiment for emerging market currencies, as well as the Federal

Reserve's outlook¹⁷ beyond interest rate cuts. For South Africa, risks such as debt problems, partly due to the cash-strapped power utility, Eskom, continue to put pressure on the rand. The Medium-Term Budget Policy Statement (MTBPS) released on October 30, 2019 showed deteriorating debt and deficit metrics, while the real GDP growth forecast for 2019 has been revised down from 1.5 percent, announced in the February 2019 Budget, to 0.5 percent. The outcome of the MTBPS, especially the increase in debt and the lingering uncertainty over Eskom's debt restructuring may have a negative impact on Moody's ratings outlook review scheduled for November.

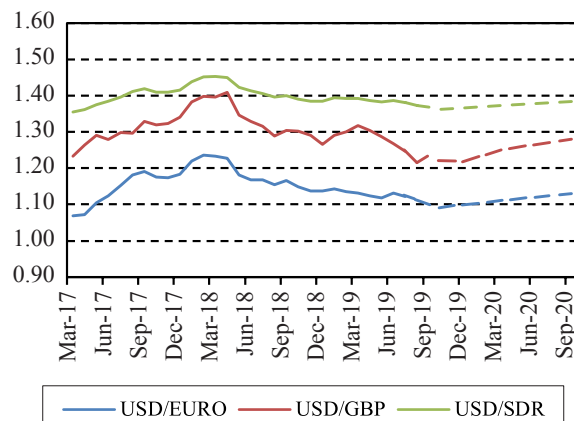
Prospects of monetary policy easing in developed economies should benefit the rand against the US dollar, should South Africa's real interest rates remain more attractive than its emerging markets peers. However, the full benefit of lower global rates will likely be diminished by trade tensions, slowing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

Chart 4.9: ZAR against USD and SDR



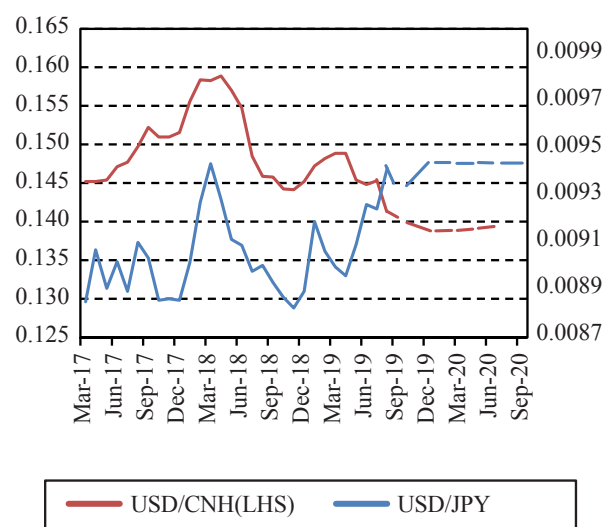
Source: Reuters

Chart 4.10A: Exchange Rates against the USD



Source: Reuters

Chart 4.10B: BWP Exchange Rates against USD



Source: Reuters

The US dollar is expected to depreciate against major international currencies in the next three quarters (Chart 4.10A and Chart 4.10B), amid expectations of a slowdown in the US economy due to the effects of the trade war between the US and China and heightened pressure on the Fed to reduce interest rates further¹⁸ in order to ease financial conditions and encourage business.

¹⁷ The US economy, like other economies around the world, is facing some longer-term challenges; low growth, low inflation and low interest rates on the back of slowing global growth, uncertainty around trade and geopolitical issues. Thus, the Fed has less room to cut rates to support the economy.

¹⁸ The Fed cut its benchmark interest rate as an insurance policy against the effects of trade tensions, by a quarter of a percentage point during its September meeting to a range of 1.75-2 percent, the second reduction in borrowing costs since the financial crisis a decade ago.

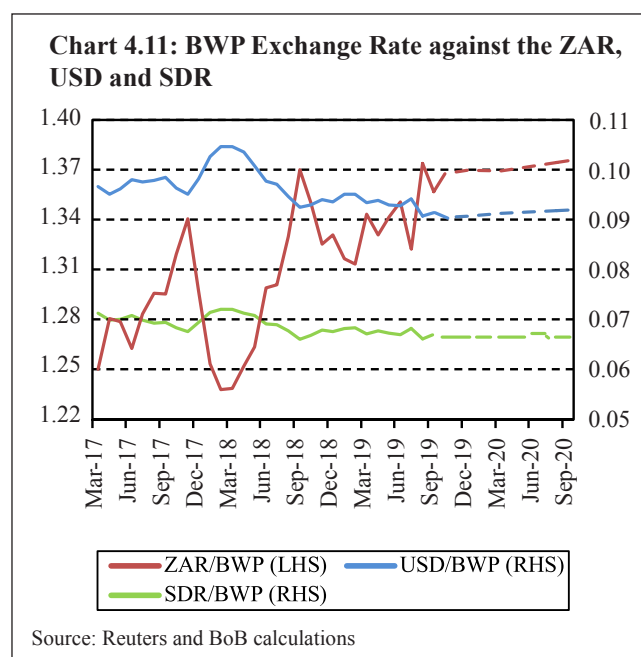
It is anticipated that the British pound will appreciate against the US dollar on the back of renewed expectation that Britain will leave the European Union (EU) with a deal, an outcome looking more likely after the EU agreed to extend the Brexit deadline to January 31, 2020. Furthermore, the Bank of England is expected to increase interest rates gradually if Britain manages to exit the EU with a transition deal to absorb the economic shock. This is because a transition deal would have positive economic shocks that would need to be moderated through an increase in interest rates. However, the uncertainty over the future of the global trading system and the form that Brexit will take are weighing on the UK economic performance. Meanwhile, the euro is expected to appreciate against the US dollar as markets are pricing-in another rate cut by the Fed in the coming months.

For Japan, the expectation is that the Bank of Japan will, like the USA, ease monetary policy in response to risks of weakening momentum if a global slowdown derails economic recovery; thus the Japanese yen to be stable against the US dollar. Investors continue to use the yen to hedge against risk inherent in emerging markets assets, and the escalating trade tension between the US and China.

The Chinese renminbi is expected to depreciate marginally against the US dollar in the next three quarter (Chart 4.10B) on the back of the resurgence of risk-off sentiments as the Chinese authorities are expected to maintain their tight grip on the renminbi and allow it to weaken further against the dollar to counteract the impact of the ongoing trade war with the US and a slowing economy. The People's Bank of China set its renminbi mid-point at an 11-year low against the dollar in response to US tariffs increase on USD300 billion of Chinese imports that came into effect on September 1, 2019. However, the renminbi is expected to recover against the US dollar by March 2020, as markets price-in another rate cut by the Fed.

Overall, forecast movements of the SDR constituent currencies would result in the appreciation of the SDR against the US dollar (Chart 4.10A). The Pula is expected to depreciate against the SDR

currencies, however, at a slower rate compared to the rand depreciation, and therefore, lead to an appreciation¹⁹ of the Pula against the rand (Chart 4.11). The expected appreciation of the Pula against the South African rand will help moderate imported inflation.



Risks broadly unchanged

Risks to the inflation outlook identified at the August 2019 MPC meeting remain relevant. On the domestic front, upside risks relate to any considerable upward adjustment in administered prices and government levies and/or 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 prospects of weak global economic activity (exacerbated by the protracted 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 could lead to subdued inflation.

¹⁹ The movement of the Pula against the SDR constituent currencies largely reflects the performance of the South African rand against the SDR constituent currencies.

5. OCTOBER 2019 MONETARY POLICY COMMITTEE DECISION

At the meeting held on October 31, 2019, the MPC of the Bank of Botswana decided to maintain the Bank Rate at 4.75 percent. Inflation increased from 2.9 percent in August 2019 to 3 percent in September, the lower bound of the Bank's objective range of 3 – 6 percent. Inflation is forecast to breach the lower bound of the objective range in the near term, mainly reflecting base effects associated with the increase in domestic fuel prices in the fourth quarter of 2018. However, inflation is projected to revert to within the objective range in the second 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, lower growth in global economic activity, technological progress and productivity improvement present downside risks to the outlook.

Real Gross Domestic Product (GDP) grew by 3.9 percent in the twelve months to June 2019, compared to a faster expansion of 4.9 percent in the corresponding period in 2018. The lower increase in output is mainly attributable to a deceleration in growth of the mining sector. Growth in non-mining GDP also slowed in the review period.

Mining output grew by 1.4 percent in the year to June 2019, compared to an increase of 5.6 percent in the corresponding period in 2018. The lower increase is, in the main, due to the significant reduction in growth of the diamond output from 11.8 percent to 1 percent in the review period. The decrease in diamond output is mainly due to the decline in production by Orapa Mine, following a planned plant shutdown in April 2019. Non-mining GDP grew by 4.2 percent in the 12-month period to June 2019, compared to 4.8 percent in the corresponding period ending in June 2018. The lower expansion in non-mining GDP was largely due to a slower growth of the trade, hotels and restaurants sector, mainly reflecting weak performance in the downstream diamond industries.

Projections by Government indicate that domestic economic activity will expand by 4.3 percent and 4.6 percent in 2019 and 2020, respectively. 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. Furthermore, 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 not adding to inflationary pressures going forward.

Global output growth is expected to ease to 3 percent in 2019, the lowest since the global financial crisis of 2008-9, down from 3.6 percent in 2018. The slowdown is due to, among other factors, broad-based deceleration in growth of industrial output and trade as well as low business confidence and weaker investment amid rising trade and geopolitical tensions. Furthermore, global economic performance is undermined by lack of traction of structural reforms in the advanced economies and China while country specific factors weigh down on growth in some emerging market economies.

Overall, global output is expected to expand modestly by 3.4 percent in 2020. The projected recovery, to be mainly driven by emerging markets and developing economies, remains precarious with elevated downside risks in an environment of policy uncertainty and sustained negative impact of trade and geopolitical tensions on business confidence, investment and growth. Regionally, economic activity in South Africa remains subdued and the South African Reserve Bank projects GDP growth rates of 0.6 percent and 1.5 percent in 2019 and 2020, respectively.

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 inflation being within the objective range of 3 – 6 percent in the medium term. Consequently, the MPC decided to maintain the Bank Rate at 4.75 percent.

The remaining MPC meeting is scheduled for December 5, 2019, at which dates for next year will be announced.

