MONETARY POLICY REPORT

AUGUST 2021

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 on a regular or timely basis. 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 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 consideration and approval, as appropriate, by His Excellency, the President. In addition, the Bank uses the Bank Rate to influence short-term interest rates to steer the economy through the business cycles, thus contributing to sustainable economic growth.

In evaluating policy options, the Bank implements a forward-looking monetary policy framework with a central role for a medium-term inflation forecast. The Bank sets the policy to direct 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 evaluated on a rolling basis, because monetary policy affects price developments with a lag estimated at up to four quarters. A proactive approach to setting policy necessitates a continuous review of the inflation outlook.

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

1.3 Decision-making process

Monetary policy is implemented in line with the decisions of the Monetary Policy Committee (MPC). The Committee comprises: Governor (Chairman); Deputy Governors; Chief Operating Officer; Director and Deputy Directors of the Research and Financial Stability Department responsible for monetary policy and financial stability; 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 or more per year, as necessary, during which the monetary policy stance is determined. Prior to the commencement of the year, the dates for the MPC meetings for the ensuing year are announced. As may be required and expedient to do so, the MPC may hold out-of-calendar meetings.

1.4 Announcement of the monetary policy decision

The monetary policy decision is announced through a Press Release shortly after each MPC meeting. The Press Release informs the public of the Committee's decision regarding the Bank Rate and the reasons for the policy choice. The Governor holds a Press Briefing to allow for interaction with members of the media and to promote understanding of the Bank's economic analysis and policy stance (See Box 6 for further information on central bank communication).

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

2. EXECUTIVE SUMMARY

In 2021, monetary policy is being implemented in the context of projections for higher inflation in the near term, associated with upward adjustment of taxes/levies and administered prices (Box 1), a modest recovery in domestic demand resulting from the easing of containment measures due to deployment of effective COVID-19 vaccines, and projected modest increase in foreign prices. Overall, the current state of the economy and the outlook for both domestic and external economic activity provide scope for maintenance of an accommodative monetary policy to support durable recovery and economic activity.

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 preserving price stability without undermining economic activity.

Globally, there has been a rebound in output growth, particularly for advanced economies. The United States of America (US)'s GDP grew by an annualised 6.5 percent in the second quarter of 2021, compared to a revised expansion of 6.3 percent in the first quarter of 2021, supported by the fiscal stimulus packages in response to the COVID-19 pandemic as well as accelerated pace of COVID-19 vaccinations. Similarly, GDP in the UK expanded (quarter-on-quarter) by 4.8 percent in the second quarter of 2021, from a contraction of 1.6 percent in the first quarter of 2021, driven mostly by a substantial increase in private consumption as the country eased COVID-19 restrictions. The GDP for the Eurozone grew by 2 percent in the second quarter of 2021, from a contraction of 0.3 percent in the first quarter of 2021, as the currency union countries eased COVID-19 containment measures aimed at curbing the spread of the pandemic. Regionally, the South African output expanded by an annualised 4.6 percent in the first quarter of 2021, following an increase of 5.8 percent in the fourth quarter of 2020.

The global economic outlook for 2021 is unchanged in the IMF's July 2021 World Economic Outlook (WEO) Update, but with offseting revisions for the regions. Prospects for advanced economies are much stronger compared to emerging market economies owing to expectations of widespread vaccine availability, effective vaccination rollout programmes and additional fiscal support particularly in the US. The global economy is forecast to expand by 6 percent in 2021, from an estimated contraction of 3.2 percent in 2020, reflecting expectations of strengthening economic activity in the latter part of the year largely induced by additional fiscal support and the rollout of effective COVID-19 vaccines.

The global rough diamond price index increased in the second quarter of 2021 as COVID-19 restrictions continued to ease in most countries, thus improving the manufacturers' demand for rough diamonds and diamond trade, generally. In the second quarter of 2021, international oil prices increased, averaging marginally above USD65 per barrel, influenced by the expansion in demand associated with the rollout of COVID-19 vaccines. Meanwhile, the United Nations' Food and Agriculture Organisation (FAO) food price index increased in the second quarter of 2021, supported by the rise in vegetable oil, cereal and dairy prices.

Domestically, headline inflation averaged 6.7 percent in the second quarter of 2021, higher than the 1.9 percent in the second quarter of 2020, mostly accounted for by the increases in levies/taxes and the upward adjustment in administered prices and associated second-round effects. Inflation is forecast to remain above the upper bound of the Bank's 3 - 6 percent objective range in the short term. Nonetheless, inflation is expected to revert to within the desired objective range in the second quarter of 2022. Compared to the June 2021 forecast, inflation is projected to be slightly higher in the short term, mainly reflecting the upward revision in forecasts for trading partner countries inflation and international commodity prices, as well as the improvement in the domestic economic activity in the first quarter of 2021 than previously projected. However, the current inflation projection is lower in the medium term compared to the June 2021 forecast due to the downward revision in South African inflation and the expected appreciation of the Pula against the rand.

Overall, risks to the inflation outlook are assessed to be skewed to the upside. These risks include the potential for increase in international commodity prices beyond current forecasts; persistence of supply constraints due to possible maintenance of travel restrictions and lockdowns; and domestically-based risk factors relating to second-round effects of the recent increases in administered prices and inflation expectations that could lead to generalised higher prices. Furthermore, aggressive action by governments (for example, the Economic Recovery and Transformation Plan (ERTP)) and major central banks to bolster aggregate demand, as well as the successful rollout of the COVID-19 vaccination programmes, could add pressure to inflation. However, these risks are moderated by the possibility of weak domestic and global economic activity, with a likely further dampening effect on productivity due to periodic lockdowns and other forms of restrictions in response to the emergence of new COVID-19 variants. A slow rollout of vaccines resulting in the continuance of weak economic activity and the possible decline in international commodity prices could also result in lower inflation, as would capacity constraints in implementing the ERTP initiatives in full.

Botswana's Gross Domestic Product (GDP) contracted by 8.6 percent in the year to March 2021, compared to 2.2 percent growth in the corresponding period in 2020, attributable to the contraction in production of both the mining and non-mining sectors, resulting from the negative impact of the COVID-19 pandemic containment measures. The prevailing accommodative monetary conditions, reforms to further improve the business environment, and government interventions against COVID-19, including vaccine rollouts, the implementation of the ERTP and the Industry Support Facility, should generally be positive for economic activity in the medium term. The domestic economy is forecast to rebound to a growth of 8.8 percent in 2021 from a contraction of 8.5 percent in 2020.

Annual growth in commercial bank credit declined from 6.4 percent in June 2020 to 5.3 percent in June 2021, reflecting, in part, the somewhat subdued demand for credit, as well as restrictive supply of credit by banks on account of the uncertainty created by the COVID-19 pandemic.

At the end of May 2021, the official foreign exchange reserves amounted to P51 billion, a decrease of 22.8 percent from P66.1 billion in May 2020. The decrease was a result of the drawdown in foreign exchange reserves to finance government financial obligations and international payments, notably import of goods and services. The current account of the balance of payments (BoP) recorded a surplus of P4.7 billion in the first quarter of 2021, compared to a revised deficit of P2.4 billion in the corresponding period of 2020, which was the lowest recorded in 2020,with the highest deficit of P7.5 billion recorded in the second quarter of 2020.

Following the annual review of the exchange rate policy in January 2021, an annual downward rate of crawl of 2.87 percent was maintained for 2021, with a view to enhancing domestic industry competitiveness in global markets and in response to the adverse impact of the COVID-19 pandemic on the economy. Consequently, the nominal effective exchange rate (NEER) of the Pula depreciated by 2.8 percent in the twelve months to July 2021. Against the basket currencies, the Pula depreciated by 9.5 percent against the South African rand but appreciated by 3 percent against the SDR in the twelve months to July 2021. In the year to June 2021, the REER appreciated by 1.1 percent due to the positive inflation differential (4.1 percent) between Botswana and trading partner countries as domestic inflation accelerated above the objective range.

3. RECENT ECONOMIC DEVELOPMENTS

3.1 Recent global economic developments

Global growth subdued

According to July 2021 WEO Update, the global economy is estimated to have contracted by 3.2 percent in 2020 (Table 3.1), a 0.1 percentage point downgrade from the April 2021 WEO. The decline in global output for 2020 was markedly lower than the 0.1 percent contraction recorded in the 2008/09 global financial crisis, and the worst contraction since the Great Depression of the 1930s. Furthermore, for the first time, all regions experienced negative growth in 2020 as the outbreak and spread of the COVID-19 virus constrained demand and disrupted supply chains on an unprecedented scale. The pandemic took a turn for the worse in some parts of the world in the first half of 2021, with the emergence of the new variants of the virus. However, speedy vaccine rollouts in some regions, particularly in the advanced economies, helped contain the spread of the virus in those countries. Some advanced economies continue to implement new fiscal measures to support economic growth, while emerging economies are striving to rebuild fiscal buffers.

The US economy expands

The US output grew by an annualised 6.5 percent in the second quarter of 2021, compared to an expansion of 6.3 percent in the first quarter of 2021, supported by the fiscal stimulus packages in response to the pandemic and the accelerated pace of COVID-19 vaccinations. The realised expansion reflected increases in consumer spending, non-residential fixed investment, exports, and local government spending.

Euro area growth expands

In the euro area, GDP grew by 2 percent in the second quarter of 2021, rebounding from a contraction of 0.3 percent in the first quarter and beating the market expectation of 1.5 percent growth. The expansion reflected the continued re-opening efforts amid rapid pace of COVID-19 vaccinations and ongoing government support. Among the bloc's largest economies, output in Spain, Italy, Germany and France expanded by 2.8 percent, 2.7 percent, 1.5 percent and 0.9 percent, respectively.

UK economy expands

GDP in the UK expanded (quarter-on-quarter) by 4.8 percent in the second quarter of 2021, from a contraction of 1.6 percent in the previous quarter, driven mostly by a substantial increase in private consumption as the country eased COVID-19 restrictions.

Emerging markets' growth expand

Output growth in emerging markets increased in the first quarter of 2021, primarily due to improved external and domestic demand arising from relaxation of containment measures that were imposed to contain the spread of COVID-19, as well as the rollout of COVID-19 vaccines. Growth was also supported by continued strong output growth in China, as well as accommodative monetary and fiscal stimulus implemented to cushion the economies from the COVID-19 pandemic. Meanwhile, China's economy grew by 7.9 percent in the second quarter of 2021, compared to a record 18.3 percent growth in the first quarter of 2021, because of higher raw material costs, a slowdown in factory activity and new COVID-19 outbreaks in some regions. In this case, output expansion was boosted by higher retail sales, as domestic consumption, a key driver of growth, improved. Moreover, growth was helped by the resilient export sector as well as continued government support for smaller firms.

In India, GDP grew, year-on-year, by 1.6 percent in the first quarter of 2021, from a revised growth of 0.5 percent in the fourth quarter of 2020. The expansion was mainly driven by state spending and manufacturing sector growth.

South African economy slows

Regionally, output in South Africa expanded by an annualised 4.6 percent in the first quarter of 2021, lower than the revised increase of 5.8 percent in the fourth quarter of 2020. The largest drivers of growth in the first quarter were mining, finance and trade industry, which expanded by 18.1 percent, 7.4 percent and 6.2 percent, respectively.

Table 3.1: Growth Estimates and Projections

	Estimate		Projection	
	2019	2020	2021	2022
Global	**2.8**	**-3.2**	**6.0**	**4.9**
Advanced economies	**1.6**	**-4.6**	**5.6**	**4.4**
USA	2.2	-3.5	7.0	4.9
Euro area	1.3	-6.5	4.6	4.3
UK	1.4	-9.8	7.0	4.8
Japan	0.0	-4.7	2.8	3.0
EMDEs	**3.7**	**-2.1**	**6.3**	**5.2**
China	6.0	2.3	8.1	5.7
Brazil	1.4	-4.1	5.3	1.9
India	4.0	-7.3	9.5	8.5
Russia	2.0	-3.0	4.4	3.1
South Africa	0.2	-7.0	4.0	2.2
Botswana	**3.0**	**-8.5**	**8.3 (8.8)**	**6.4 (5.5)**

Source: IMF WEO July 2021 Update and MFED for Botswana

Note: EMDEs stands for emerging market and developing economies, while figures in parentheses are forecasts from the MFED.

Global commodity prices

Rough diamond prices increased in the second quarter of 2021

The global rough diamond price index increased by 7.4 percent from 143.9 points in the first quarter of 2021 to 154.6 points in the second quarter of 2021 as most countries continued to ease COVID-19 restrictions and rolled out effective vaccines, thus, improving manufacturers' demand and trade for rough diamonds. However, the recovery in demand remains fragile owing to ongoing restrictions on the movement of people and goods. The global rough diamond price index averaged 164.7 points in July 2021.

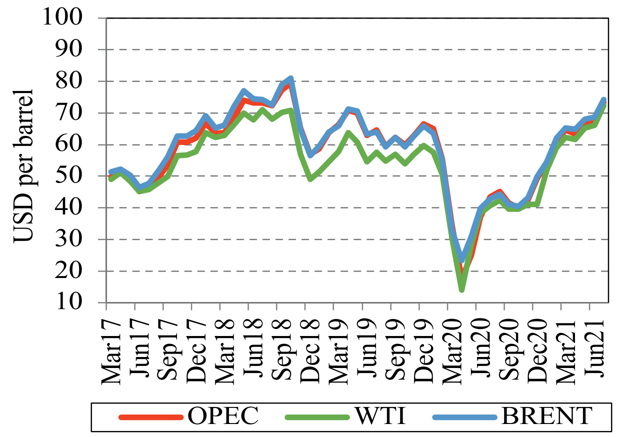
The global polished diamond price index increased by 1.4 percent from 207.7 in the first quarter of 2021 to 210.7 in the second quarter. In June 2021, the global polished price index averaged 212.1 points, higher than the 210.4 points in May, as the polished diamond market showed signs of improvement due to continued increase in demand from the US and China.

Oil prices increased in the second quarter of 2021

International oil prices averaged slightly above USD65 per barrel in the second quarter of 2021 (Chart 3.1). The price of the Organisation of the Petroleum Exporting Countries (OPEC) reference crude oil basket, Brent crude and West Texas Intermediate (WTI) increased by 12 percent, 13.3 percent and 14 percent, from an average of USD60.01 per barrel, USD60.57 per barrel and USD57.84 per barrel in the first quarter of 2021 to an average of USD67.32 per barrel, USD68.59 per barrel and USD66.05 per barrel, respectively, in the second quarter of 2021. International oil prices increased, in part, supported by the recovery in global demand following the relaxation of some COVID-19 containment measures and effective rollout of vaccination programmes especially in advanced economies. Furthermore, economic rebound in major economies, supported by stimulus programmes, also boosted the demand for oil in the second quarter of 2021.

International oil prices averaged slightly above USD70 per barrel in July 2021. The OPEC reference crude oil basket averaged USD73.46 per barrel, Brent crude averaged USD74.35, while the price of WTI averaged USD72.38 per barrel. The increase in oil prices was, in part, due to increased global oil demand supported by widespread COVID-19 vaccination programmes in the US, Europe, and Asia as well as relaxation of COVID-19 containment measures, which outweighed concerns about the COVID-19 crisis in India, the world's third largest oil. Moreover, oil prices were underpinned by the decline in the US oil inventories, and additional fiscal stimulus implemented in some countries.

Chart 3.1: Oil Prices



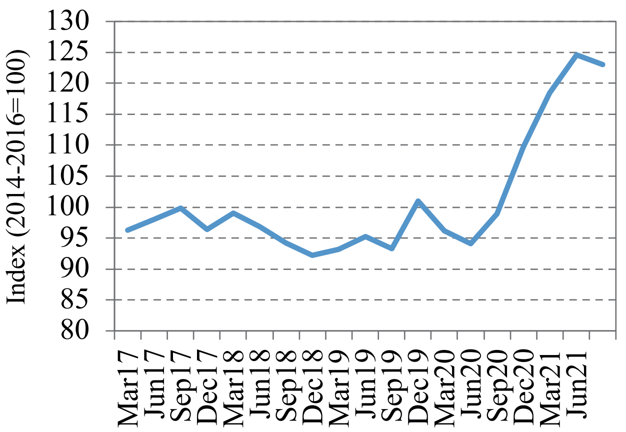
Source: OPEC and US Energy Information

Food prices increased in the second quarter of 2021

According to FAO, the global food price index averaged 124.5 points in the second quarter of 2021, a 7.5 percent increase from an average of

115.9 points in the first quarter of 2021 (Chart 3.2). The increase in prices was attributable to higher vegetable oil, cereal and dairy prices. Moreover, brisk trade activity supported by the recovery in global demand following relaxation of some COVID-19 containment measures helped to increase food prices. Furthermore, the rising concerns over production in the Southern hemisphere and dry conditions in many parts of Europe resulted in overall higher food prices. The food price index averaged 123 points in July 2021, a decrease of 1.2 percent from June 2021, but 31 percent higher than in the corresponding period last year.

Chart 3.2: Food Price Index

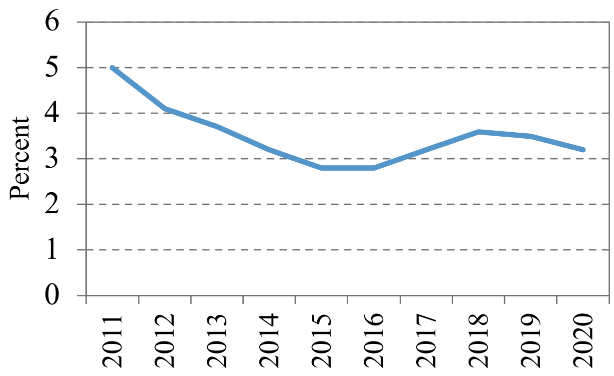


Source: Food and Agriculture Organisation

Global inflation improved across the regions

Inflation increased globally, in the second quarter of 2021, owing to the rise in commodity prices, as well as improving global economic demand as most economies eased movement restrictions and deployed effective COVID-19 vaccines. For advanced economies, inflation increased from 1.8 percent in the first quarter of 2021 to 3.1 percent in the second quarter, consistent with the faster rates of deployment of vaccines, particularly in the UK and US. Similarly, inflation increased from 1.8 percent to 3.5 percent in emerging market economies in the same period. Global inflation declined from 3.5 percent in 2019 to 3.2 percent in 2020 (Chart 3.3).

Chart 3.3: Global Inflation

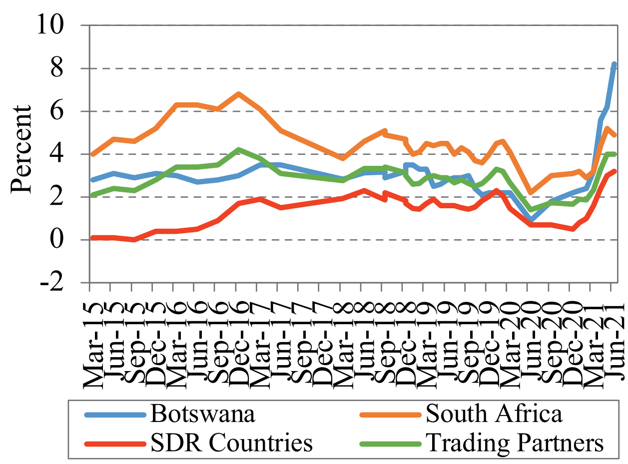


Source: IMF April 2021 WEO

In South Africa, headline inflation averaged 4.8 percent in the second quarter 2021 from an average of 3.1 percent in the first quarter of 2021. Inflation decreased from 5.2 percent in May 2021 to 4.9 percent in June, remaining within the SARB's target range of 3 – 6 percent.

The average trade-weighted inflation for Botswana's trading partners (Chart 3.4) was unchanged at 4 percent between May and June 2021.

Chart 3.4: Botswana Inflation and International Inflation



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

Accommodative monetary policy stance maintained

In the most recent policy decisions in advanced economies (Table 3.2), the European Central Bank (ECB) maintained the deposit rate, refinancing rate and lending rate at -0.50 percent, zero and 0.25 percent, respectively, in July 2021, to support the Eurozone economy. The ECB also maintained the pandemic emergency purchase programme (PEPP) at €1 850 billion. Furthermore, asset purchases are scheduled to continue at a monthly pace of €20 billion under the asset purchase programme (APP), along with additional net asset purchases of €120 billion. Moreover, the net purchases under PEPP is scheduled to continue until the end of March 2022, while the principal payments from maturing securities will be reinvested until at least the end of 2023. The ECB is expected to continue to provide ample liquidity through its refinancing operations as part of the measures for supporting economic recovery and counteracting the negative impact of the pandemic on the projected inflation path.

At the July 2021 meeting, the US Federal Open Market Committee (FOMC) left the target policy rate range unchanged at 0 - 0.25 percent, as indicators of economic activity and employment showed an improvement, amid progress on vaccinations and strong policy support. Financial conditions remained accommodative, reflecting, in part, policy measures to support the economy and the flow of credit to households and businesses. The Fed indicated that it would continue to increase its holdings of Treasury securities and agency mortgage-backed securities by at least USD80 billion and USD40 billion per month, respectively, until substantial progress has been made towards the maximum employment and price stability goals. The FOMC further indicated that it expects to maintain the target range until it is confident that economic recovery is entrenched, and on track to achieve its maximum employment and price stability goals.

The Bank of England (BoE) maintained the Bank Rate at 0.1 percent and the total target stock of its asset purchases at £895 billion in August 2021, as the Monetary Policy Committee judged that the existing stance of monetary policy remained appropriate. The Committee stated that it does not intend to tighten monetary policy until there was clear evidence that spare capacity had been eliminated and inflation was reaching its 2 percent target.

The Bank of Japan (BoJ) kept the key short-term interest rate unchanged at -0.1 percent and maintained the long-term government bond yield at around zero at the July 2021 meeting. In addition, the BoJ agreed to continue purchasing exchange-traded funds (ETFs) and Japan real estate investment trusts (JREITs) until the amounts outstanding increased to approximately 12 trillion yen and 180 billion yen, respectively. As regards the commercial paper and corporate bonds, the BoJ maintained the amounts outstanding at 2 trillion yen and 3 trillion yen, respectively. In addition, until the end of March 2022, the bank will conduct additional purchases with an upper limit on the amount outstanding of these assets of about 20 trillion yen in total.

In emerging market economies, the Central Bank of Brazil increased the policy rate by 100 basis points to 5.25 percent in August 2021, the fourth raise in 2021, amid uncertainty about economic growth and rising inflationary pressures. In addition, the Central Bank of Brazil announced that it will raise the policy rate by another 100 basis points in Septermber 2021 to control inflation. Similarly, the Central Bank of Russia (CBoR) increased the key rate by 100 basis points to 6.5 percent in July 2021, following a 50 basis points increase at the previous meeting, as aggregate demand increased faster than output expansion, and inflation expectations remained elevated. CBoR also signalled further rate increases at the upcoming meetings. Meanwhile, the People's Bank of China (PBoC) maintained the one-year Loan Prime Rate (LPR) for the fifteenth consecutive month at 3.85 percent in July 2021, as the economy continues to recover from the downturn caused by the COVID-19 pandemic.

The SARB maintained the repo rate at 3.5 percent in July 2021, following a cumulative 300 basis points rate cut in 2020 to support an economy that was already in recession before the pandemic shock. The SARB considered the risks to the growth outlook to be balanced while risks to the short-term inflation outlook were assessed to be on the upside. The SARB expected inflation to be contained and to remain well below the 4.5 percent midpoint of the target range in 2021, due to the economic contraction and subsequent slow recovery. Moreover, the SARB noted that monetary policy and repurchase rate level remains highly accommodative and will remain so even with normalisation of interest rate levels to rising inflation. The SARB signals a 25 basis points increase in the repo rate in the fourth quarter of 2021 and in each quarter of 2022.

In August 2021, the Reserve Bank of India (RBI) maintained the policy rate at 4 percent and the reverse repo rate at 3.35 percent to support economic recovery and help mitigate the negative impact of the COVID-19 pandemic amid high inflationary pressure. Meanwhile, the RBI revised its projection for retail inflation for the year 2021/22 from 5.1 percent to 5.7 percent, and highlighted the need to reverse policy in future if price pressures fail to abate.

Table 3.2: Monetary Policy Decisions

Central Bank	Latest Meeting	Current Policy Rate (Percent)	Change from Previous Meeting
Bank of Botswana	August 2021	3.75	No change
SARB	July 2021	3.50	No change
US Federal Reserve	July 2021	0 – 0.25	No change
BoE	August 2021	0.10	No change
ECB	July 2021	0.00	No change
BoJ	July 2021	-0.10	No change
PBoC	July 2021	3.85	No change
Brazil	August 2021	4.25	Increased by 100 basis points
India	August 2021	4.00	No change
Russia	July 2021	6.50	Increased by 100 basis points

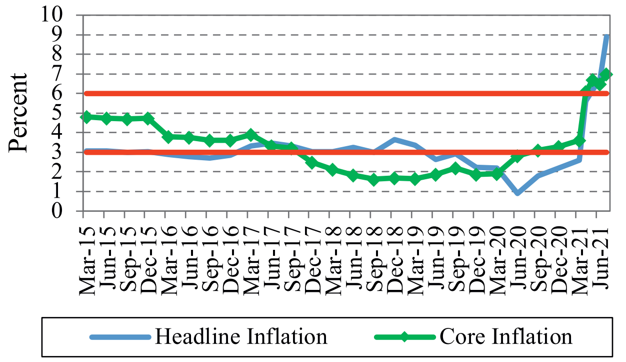
Source: Surveyed central banks' websites.

3.2 Domestic inflation environment

Headline inflation increased in the second quarter of 2021

Headline inflation averaged 6.7 percent in the second quarter of 2021, from 1.9 percent in the second quarter of 2020 (Chart 3.5 and Table 3.3) mostly accounted for by the increases in levies/ taxes and upward adjustment in administered prices and associated second-round effects. Headline inflation rose from 8.2 percent in June to 8.9 percent in July 2021, remaining above the upper bound of the Bank's medium-term objective range of 3 – 6 percent. The increase in inflation between June and July 2021 was mainly on account of the upward adjustment in domestic fuel prices in July 2021, which added approximately 0.62 percentage points to inflation in the same month.

Chart 3.5: Botswana Headline and Core Inflation

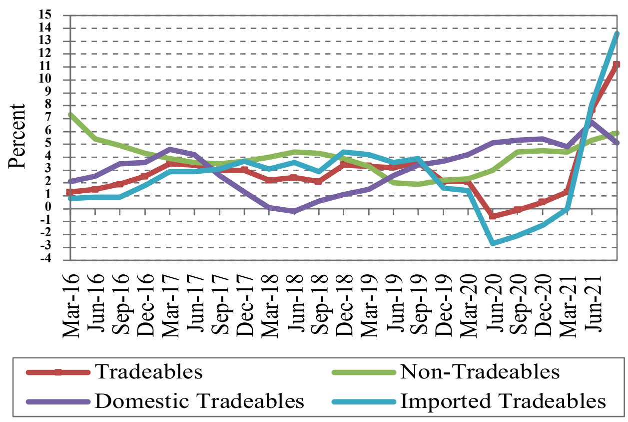


Source: Statistics Botswana and Bank of Botswana
Note: Core Inflation is headline inflation excluding administered prices.

Prices for domestic and imported tradeables increased in the second quarter of 2021

Inflation for domestic tradeables increased from an average of 4.5 percent in the second quarter of 2020 to an average of 6.7 percent in the second quarter of 2021 (Charts 3.6 and 3.7), reflecting an increase in food prices. Similarly, imported tradeables inflation increased from an average of -0.2 percent to 8.1 percent in the same period, mainly due to base effects associated with the decrease in domestic fuel prices in the corresponding period in 2020. As a result, all tradeables inflation increased from an average of 1 percent in the second quarter of 2020 to an average of 7.7 percent in the corresponding quarter in 2021, while inflation for non-tradeables increased from an average of 3.2 percent to an average of 5.3 percent in the same period. In July 2021, domestic tradeables, imported tradeables, non-tradeables and all tradeables inflation were 5.1 percent, 13.6 percent, 5.9 percent and 11.2 percent, respectively.

Chart 3.6: Inflation for Tradeables and Non-Tradeables

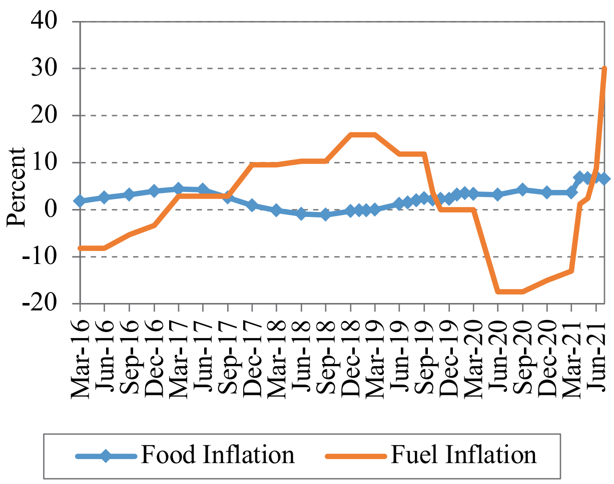


The upward trend in non-tradeables inflation since June 2019 and domestic tradeables inflation from June 2018 is mainly due to the increase in prices for administered items and food, respectively. The increase in food prices was partly a result of bad weather conditions experienced in the 2018/19 ploughing season, and economic disruptions occassioned by COVID-19 in 2020. Accordingly, therefore, upward trends in both non-tradeables and domestic tradeables inflation are not a result of domestic demand pressures, as the output gap is estimated to be negative (Section 4.2 refers).

Core inflation measures increased in the second quarter of 2021

The trimmed mean inflation (CPITM) increased to 6.4 percent in the second quarter of 2021 from 1.5 percent in the second quarter of 2020, while inflation excluding administered prices (CPIXA) averaged 6.5 percent compared to 2.7 percent in the same period due to the increase in prices for food and non-alcoholic beverages (Table 3.3). Similarly, inflation excluding food and fuel (CPIXFF) averaged 6.5 percent in the second quarter of 2021, higher than the 2.8 percent in the corresponding quarter of 2020, mainly because of the increase in administered prices. In July 2021, CPITM, CPIXA and CPIXFF were 8.4 percent, 7 percent and 7.1 percent, respectively.

Chart 3.7: Food and Fuel Inflation



Source: Statistics Botswana and Bank of Botswana

Table 3.3: Annual Price Changes for Categories of Goods and Services (Percent)

Category of commodities	**Basket Weights**	**July 2021**	**Q2 2021**	**Q2 2020**
Food and non-alcoholic beverages	13.6	6.5	6.8	3.3
Alcoholic beverages and tobacco	4.3	8.2	11.3	3.7
Clothing and footwear	6.0	3.5	3.7	2.0
Housing, water, electricity, gas and other fuels	17.5	8.4	7.2	6.0
Furnishing, h/h equipment and routine maintenance	4.9	4.3	3.4	2.7
Health	3.4	2.7	3.0	1.3
Transport	23.4	20.9	11.2	-2.1
Communications	6.9	1.7	1.6	0.4
Recreation and culture	2.8	4.4	4.0	-0.6
Education	4.6	1.8	1.8	4.7
Restaurants and hotels	3.7	3.3	3.0	3.6
Miscellaneous goods and services	9.0	6.6	5.9	1.2
Annual Inflation (All items)	**100.0**	**8.9**	**6.7**	**1.9**
CPITM		8.4	6.4	1.5
CPIXA		7.0	6.5	2.7
CPIXFF		7.1	6.5	2.8

Source: Statistics Botswana and Bank of Botswana calculations

Box 1: Administered Prices

The two prominent channels through which governments can have a direct impact on price-setting are levies/taxes and administered prices. However, the analysis given in this box aims to define and analyse the composition of administered prices in Botswana, as well as the recent adjustments in administered prices and their impact on headline inflation. Administered price items in the 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.

It is worth noting that administered prices have a transitory impact (over a period of up to one year), implying that the supply-side inflationary (deflationary) pressures emanating from the upward (downward) adjustment in administered price are quite pronounced in the short run. Therefore, monetary policy does not have any direct influence on these price changes and, therefore, would not trigger a direct policy response. Policy may, nevertheless, respond to the resultant second round effects as free market prices also react, particularly in the medium term, as it is the relevant time frame for monetary policy to influence the level of prices. Meanwhile, factors that are likely to have an enduring influence on inflation, such as changes in aggregate demand conditions are often subject to monetary policy influence. The approach of distinguishing between prices with a transitory and permanent impact on inflation is important for policy formulation as it helps facilitate appropriate and timely responses to any forecast deviation of inflation from the objective range.

There are currently 51 administered items (12.8 percent) out of the 400 items in the Botswana CPI basket, accounting for a significant weight of 32.3 percent in the basket (Table 3.2). Changes in the prices of these items, therefore, have a significant influence on inflation and inflation expectations as shown by the recent surge in inflation, which reflects the recent upward adjustments in VAT and administered prices. These are estimated to have added approximately 4.61 percentage points to inflation in the first half of 2021, with most of the effect expected to dissipate from the first half of 2022, consequently contributing to lower inflation in the medium term. However, second-round effects of the recently announced increases in administered prices pose upside risks to the inflation outlook. It is, therefore, critical for the internal consistency of macroeconomic policy design that administered prices and tax adjustments be set in view of their possible effects on inflation.

For this reason, the Bank monitors and calculates the prospective and actual impact of the changes in administered prices on inflation, with a view to inform the forward-looking monetary policy framework of the Bank.

Table 3.4: Administered Items

Item code	Administered prices	Weights
147	Monthly rent BHC House Type LC48	0.294
148	Monthly rent BHC Type 2 "Improved"	0.379
161	Water: 10kls per month	1.168
162	Water: 20kls per month	0.779
164	Electricity: 100kwh per month	2.143
165	Electricity: 500kwh per month	1.428
167	Paraffin per litre	0.064
237	Consultation with Government doctor	0.168
247	Rate to stay in a public hospital for 24 hours in a private ward (bed only)	0.799
261	Petrol per litre (95)	6.262
262	Diesel per litre (50ppm)	3.708
270	Road worthiness test	0.022
271	Bus fare, single, Gaborone: Mochudi	0.706
272	Minibus fare, Gaborone: Johannesburg	0.631
273	Taxi fare (not "special")	0.794
274	Bus fare, single, Gaborone: Francistown	0.653
275	Minibus fare, within cities/towns/villages	0.913
278	Railway passenger's 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 zones (per second charge)	0.004
293	Telephone charges/rate within zone (per second charge)	0.004
294	Telephone rate international (per second charge)	0.004
295	Telephone charges/rate to mobile (all mobiles)	0.005
296	Mascom charges/rate to all network (peak hour per minute charge)	0.697
297	Mascom charges/rate to all network (off/off - off peak hour per minute charge)	0.557
298	Orange charges/rate to all network (peak hour per minute charge)	0.697
299	Orange charges/rate to all network (off/off - off peak hour per minute charge)	0.557
300	Bemobile charges/rate to all network (peak hour per minute charge)	0.697
301	Bemobile charges/rate to all network (off/off - off peak hour per minute charge)	0.557
302	Mobile charge international charge (Orange + Mascom + Bemobile)	0.557
303	Prepaid phone card: short message service (SMS)	0.418
305	Mobile data pass (1GB; 1month)	0.836
328	Admission to premier league football match: uncovered stands	0.007
338	Kutlwano magazine	0.003
351	Senior Secondary School fees (public)	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 comprehensive insurance: Toyota Corolla 1.3	0.791
388	Levy + loan (P3500) interest on Self Help Housing Agency plot	0.060
390	Driver's license charge	0.025
391	Annual road tax: Hilux 2.0 pick-up	0.138
392	Annual road tax: Toyota Corolla 1.4	0.113
393	Fee for the issue of a passport	0.053
394	Council rates to house + plot valued at P200,000	0.091
397	Advertisement (20 words, Botswana Daily News newspaper)	0.025
	Total weight	**32.259**

3.3 Recent domestic economic developments

In July 2021, Statistics Botswana published rebased national accounts from 2006 prices to the new base year 2016, covering both annual and quarterly data from 2014 to the first quarter of 2021 (Box 2).

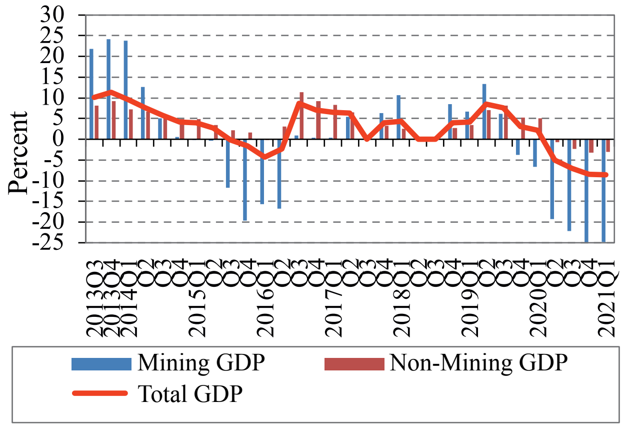
GDP contracts in the first quarter of 2021

Real GDP contracted by 8.6 percent in the twelve months to March 2021, compared to a 2.2 percent growth in the corresponding period in 2020 (Chart 3.8 and Table 3.5). The decline in output is attributable to the contraction in production of both the mining and non-mining sectors, resulting from the negative impact of the COVID-19 pandemic containment measures on overall domestic economic activity. Mining output declined significantly by 27.8 percent compared to a lesser contraction of 6.7 percent in 2020, as mining of diamonds, gold and other metal ores, other mining and quarrying, mining of coal, soda ash and salt, and mining support service activities subsectors underperformed. Notably, global demand and sales of rough diamonds were adversely affected by international movement restrictions, while gold production was low, mainly because of the diminishing resource base which negatively affected production. Coal output contracted due to lower demand at Morupule B power station, which was operating below capacity because of ongoing remedial works at the plant.

Non-mining GDP contracted by 3.1 percent in the twelve-month period ending March 2021, compared to a growth of 5 percent in the corresponding period in 2020. The decline in non-mining GDP was mainly due to contractions in output of the accommodation and food services (-35.4 percent), manufacturing (-16.2 percent) construction (-13.5 percent), diamond traders (-10.2 percent), administrative and support activities (-7.6 percent), other services (-7.4 percent), and transport and storage (-6.8 percent) sectors. In addition, deceleration in growth of the public administration and defence (from 14.9 percent to 5.8 percent), wholesale and retail sector (from 7.7 percent to 1.7 percent) and human health and social work (from 7.6 percent to 1.9 percent) contributed to the overall output decline of the non-mining sector.

Meanwhile, Statistics Botswana reported that real GDP increased by 0.7 percent in the first quarter of 2021 from 1.2 percent growth in the first quarter of 2020.

Chart 3.8: GDP Growth Rates



Source: Statistics Botswana

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

In terms of GDP by expenditure, government final consumption increased by 3.2 percent in the year to March 2021, compared to 7.9 percent in the corresponding period in 2020 (Table 3.5). This was attributable to the deceleration in growth of collective consumption and individual consumption, from 9.1 percent to 3.9 percent and 3.8 percent to 0.6 percent, respectively. Meanwhile, household final consumption contracted by 4.8 percent compared to a growth of 4 percent registered in the previous period. The contraction in household final consumption was mainly due to a contraction in household consumption expenditure and deceleration in growth of expenditure by non-profit institutions.

Gross fixed capital formation (GFCF) contracted by 12 percent in the year to March 2021, compared to the 8.8 percent growth in the corresponding period in the previous year. The contraction in GFCF was mainly due to a decline of 19.4 percent and 13.4 percent in investment in transport equipment and buildings and structures from a growth of 0.5 percent and 5.1 percent, respectively, in the previous period.

Table 3.5: Real GDP Growth by Sector and Expenditure (Percent)

	2020Q1	2020Q4	2021Q1
Total GDP	2.2	*-8.5*(-7.9)	-8.6
By Sector:			
Mining & Quarrying	-6.7	*-26.5* (-26.2)	-27.8
Non-Mining	5.0	*-3.2*(-5.9)	-3.1
Agriculture, Forestry & Fishing	-0.6	*-1.7*(2.3)	-0.9
Manufacturing	2.3	*-14.9*(-8.9)	-16.2
Water and Electricity	-42.8	*-11.7*(5.1)	20.4
Construction	3.1	*-11.4*(-11.0)	-13.5
Wholesale & Retail	7.7	*1.2*	1.7
Diamond Traders	-4.1	*-36.8*	-10.2
Transport and Storage	2.8	*-6.4*	-6.8
Accommodation & Food Services	1.1	*-28.5*	-35.4
Information & Communication Technology	5.3	*6.2*	5.3
Finance, Insurance & Pension Funding	3.8	*2.7*	3.3
Real Estate Activities	5.5	*-3.1*	-3.7
Professional, Scientific & Technical Activities	3.4	*-1.8*	-0.5
Administrative & Support Activities	3.3	*-7.3*	-7.6
Public Administration & Defence	14.9	*7.7*	5.8
Education	4.1	*-0.1*	-0.2
Human health & social work	7.6	*2.8*	1.9
Other services	2.9	*-6.1*	-7.4
By Type of Expenditure:			
Government Final Consumption	7.9	*3.6*	3.2
Household Final Consumption	4.0	*-2.7*	-4.8
Gross Fixed Capital Formation	8.8	*-7.7*	-12.0
Exports of Goods and Services	-13.1	*-18.1*	3.2
Imports of Goods and Services	6.7	*5.2*	26.3

Note: The figures in italics are revisions of the figures in brackets, previously reported in the Q4 estimates.

Source: Statistics Botswana and Bank of Botswana Calculations

Box 2: Rebasing and Revision of GDP

Rebasing of GDP is the process of replacing an old base year with a more recent base year in line with the evolution in prices. Constant price estimates are then recalculated in terms of the prices of the new base year and provides a reference point to which future values of GDP are then compared. In July 2021, Statistics Botswana published rebased estimates of GDP at current and constant prices for the period 2014 to 2020, as well as GDP estimates for the first quarter of 2021. The objective of rebasing Botswana's GDP was to take into account changes that occurred in the economy since the last rebasing exercise in 2012. The rebasing exercise presents an opportunity to incorporate new statistical methods outlined in the 2008 System of National Accounts (SNA) using the Supply and Use Tables (SUT) as the framework. It enables the GDP series to reflect a more accurate picture of the size and structure of the economy. The relevance of the GDP series is, therefore, enhanced and made more internationally comparable with other jurisdictions. The rebasing also took care of tax harmonisation with the Southern African Customs Union (SACU) regional agreements on tax collections. The 2016 base year series features 18 industry groupings versus the previous 10 industry groupings. The rebased GDP provides a better understanding of which industries are driving growth.

Changes in the Rebased Series

The nominal value of GDP in the benchmark year (2016) was revised downwards by an amount of P6.2 billion, or 3.6 percent, due to the P8.2 billion or 51.5 percent decline in taxes on products in the revised estimates, compared to the previous figures. Consequently, contributions of various sub-industries to total Gross Value Added (GVA) changed in the period 2006 to 2016. It is important to note that the GVA obtained from the GDP series based on the 2016 base year is not strictly comparable with the previously published data for GVA at current prices. This is mainly because of changes in the methodology and use of improved data sources within industries. In addition, revised estimates, particularly for Public Administration and Defence, Diamond Traders and Electricity, as well as the implementation of the latest version of the International Standard Industrial Classification (ISIC) revision 4 were mainly responsible for the changes in the composition of sub industries. As a result of these developments, the weights used to extrapolate the base-year estimates of GVA at current and constant prices in 2016 differ from the weights that were used in the 2006 base year. This, in turn, had an impact on both the level and growth rates of overall GDP as shown in the table below.

Revised Compared to Previous Estimates							
	2014	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
GDP at current prices, million Pula							
Revised estimates (2016 base year)	140 518	137 539	164 418	166 473	172 525	178 480	172 552
Previous estimates (2006 base year)	145 869	146 066	170 564	180 103	190 365	197 504	180 799
Annual growth - percent of real GDP							
Revised estimates		**-5.7**	**7.0**	**4.0**	**4.0**	**3.0**	**-8.5**
Previous estimates		**-1.7**	**4.3**	**2.9**	**4.5**	**3.0**	**-7.9**

Diamond production increased in the second quarter of 2021

Debswana produced 5.7 million carats of diamonds in the second quarter of 2021, 213.8 percent higher than the 1.8 million carats produced in the corresponding period in 2020. The overall significant increase in production is mainly due to the base effects of the impact of the COVID-19 lockdown in the second quarter of 2020. Also, demand for polished diamonds in the second quarter of 2021 continued to improve leading to strong demand for rough diamonds from midstream cutting and polishing centres, despite the negative impact on productive capacity from the severe COVID-19 wave in India during April and May 2021. Debswana's production target for 2021 has been set at 23 million carats, while production guidance for the larger De Beers Group has been revised downwards to 32-33 million carats (previously 33-34 million carats).

Production by Lucara Diamond Corporation (Karowe Mine) decreased by 12.6 percent to 80 014 carats in the first quarter of 2021, from 91 536 carats in the corresponding period in 2020. The decline was attributable to the uncertainty caused by the COVID-19 global pandemic as new infections continued to increase globally. Special stones accounted for 6.8 percent of total carats recovered during the period. With respect to quarterly performance, production for the first quarter of 2021 also decreased by 20 percent to 80 014 carats from 100 059 carats in the fourth quarter of 2020.

Budget deficit recorded in the fourth quarter of the 2020/21 fiscal year

Government budget was in deficit of P0.1 billion in the fourth quarter of the 2020/21 fiscal year (Table 3.6). The deficit was mainly due to the slightly lower Bank of Botswana and "other" revenues in the revised budget. Meanwhile, mineral revenue surpassed the revised budget largely reflecting the increase in diamond sales associated with continued gradual easing of COVID-19 travel restrictions and resumptions of business operations, as well as increased rent and licence fees from mining companies. Regarding other major revenue streams, domestic taxes (VAT) and Non-mineral Income Tax surpassed the projected tax collections in the revised budget, mainly due to the resumption of income tax payments, following deferment of income tax payments by some businesses, as part of the fiscal relief measures to alleviate the impact of the COVID-19 pandemic on domestic businesses and the domestic economy at large. Total government expenditure and net lending was P15.7 billion, lower than the P17.3 billion originally anticipated.

Government expenditure outturn for the 2020/21 fiscal year (April 2020 - March 2021) is P65.8 billion, which is P3.6 billion lower than the revised budget (or 95 percent of the revised budget estimate, same proportion to that of the 2019/20 fiscal year). The budget deficit is P14.6 billion compared to a projected higher deficit of P21 billion of the revised budget, reflecting the upward revision of revenue and grants from P48.3 billion to P51.2 billion.

Table 3.6: Quarterly Budget Outturns (P Million)

	Total Revenues and Grants	Total Expenditure and Net Lending	Budget Surplus/ Deficit
2019/20 Q4	11 713	16 614	-4 901
2020/21 Q1	12 804	14 303	-1 499
2020/21 Q2	10 284	17 636	-7 352
2020/21 Q3	12 616	18 199	-5 583
2020/21 Q4	15 542	15 666	-124

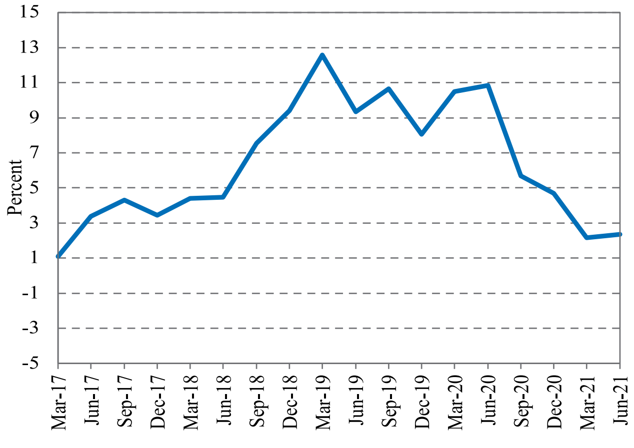
Source: Cash Flow Unit, Ministry of Finance and Economic Development

3.4 Monetary developments

Growth in banking sector assets decelerated in June 2021

Annual growth in banking sector assets decelerated from 10.8 percent in June 2020 to 2.3 percent in June 2021 (Chart 3.9). This was due to the decrease in holdings of Bank of Botswana Certificates. The overall decrease in the growth of loans and advances, which accounted for the largest proportion of commercial banks' assets (63.4 percent), also contributed to the deceleration.

Chart 3.9: Year-on-Year Commercial Banks' Growth in Total Assets



Source: Commercial Banks

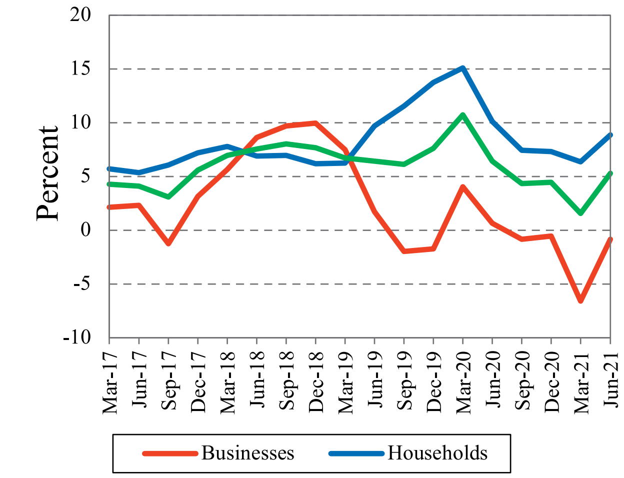
Credit growth decelerated in the year to June 2021

Growth in commercial bank credit declined from 6.4 percent in June 2020 to 5.3 percent in the twelve-month period to June 2021 (Chart 3.10). The deceleration in commercial bank credit growth is, in part, indicative of the somewhat subdued demand for credit, as well as restrictive supply of credit by banks on account of the uncertainty related to the COVID-19 pandemic. Overall, however, credit growth has maintained an upward trend since March 2021 reflecting the increase in loan uptake by households, particularly through scheme loans arrangements.

Growth in household loans decreased to 8.9 percent in the twelve months to June 2021, from 10.1 percent in the corresponding period in 2020. The lower growth is mainly attributable to the decline in credit card loans. Furthermore, personal unsecured lending and motor vehicle loans declined during the period under review. Despite the deceleration in household credit growth, the share of the sector in total lending by commercial banks increased to 65.5 percent in June 2021, from 63.4 percent in June 2020.

Lending to the business sector contracted by 0.9 percent in the twelve months to June 2021, compared to an increase of 0.6 percent in the corresponding period in 2020. Meanwhile, credit to businesses excluding parastatals increased by 1.0 percent in the year to June 2021, compared to an annual contraction of 1.6 percent in June 2020. The increase in credit to businesses excluding parastatals was mainly due to utilisation of overdraft facilities by some companies in the mining and real estate industries. Credit to parastatals contracted by 18.2 percent in the year to June 2021, compared to the 26.9 percent expansion in the twelve months to June 2020.

Chart 3.10: Year-on-Year Commercial Banks' Growth in Total Credit

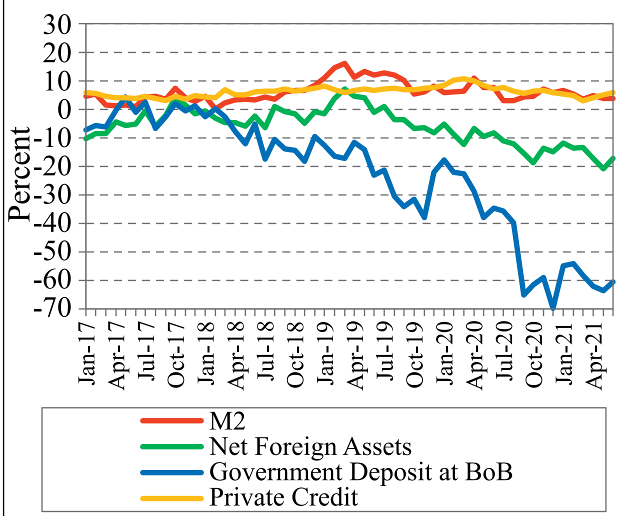


Source: Commercial Banks

Growth in money supply decelerated in June 2021

Annual growth in money supply (M2) was 3.8 percent in June 2021, lower than the 7.7 percent in the corresponding period in 2020 (Chart 3.11). The relatively low growth in money supply was largely a result of the decelerated growth in credit to the private and parastatal sectors. Meanwhile, there was a decline in net foreign assets and government deposits at the Bank of Botswana to fund government operations.

Chart 3.11: Year-on-Year Growth in Money Supply



Source: Other Depository Corporations and Bank of Botswana

The 7-day BoBC yields decreased in the second quarter of 2021

The 7-day BoBC nominal stop-out yield decreased from an average of 1.16 percent in the second quarter of 2020 to an average of 1.06 percent in the second quarter of 2021. Similarly, the real rate of interest decreased from an average of -0.75 percent in the second quarter of 2020 to an average of -5.25 percent in the second quarter of 2021.

Meanwhile, the stop-out yield for the 7-day BoBC was constant at 1.06 percent for the fourth consecutive month in July 2021. However, the real rate of interest for the 7-day BoBC decreased from -6.60 percent in June to -7.20 percent in July 2021, reflecting the increase in the inflation rate.

Effective October 30, 2020, the Bank discontinued the issuance of the 3-month BoBCs. This followed the re-introduction of the 3-month Treasury Bill, after Government increased the bond issuance programme from P15 billion to P30 billion. Box 3 discusses reforms to monetary operations.

S&P Global Ratings affirms Botswana's credit rating and maintains the negative economic outlook

In March 2021, S&P Global Ratings (S&P) affirmed Botswana's sovereign credit rating for long-term foreign and domestic currency bonds at "BBB+", and "A-2" for short-term foreign and domestic currency bonds. S&P indicated that the affirmation of the ratings was underpinned by strong, stable and predictable institutional frameworks; modest net general government debt levels; relatively strong net external position; and the positive impact of the monetary policy framework, all of which contribute to sound macroeconomic stability. S&P noted that the ratings were dependent on the trajectory of the COVID-19 pandemic, vaccination rates and movement restrictions which could influence the demand for diamonds. S&P also maintained the negative economic outlook on account of the risks that the COVID-19 pandemic continues to pose to the country's economic and fiscal performance over the next twelve months. The economic outlook could be revised to stable if the country's public budget performance improved, resulting in increased fiscal and external buffers. On the other hand, the ratings could be lowered if sustainable recovery in the demand and prices for diamonds waned, resulting in weaker fiscal and external performance.

Moody's downgrades Botswana's sovereign credit rating but changed its economic outlook from negative to stable

In April 2021, Moody's Investors Service downgraded Botswana's sovereign credit rating for long-term bonds, denominated in both domestic and foreign currency, from 'A2' to 'A3'. However, the economic outlook was changed from negative to stable. The downgrade is due to the reduction in the capacity of government to absorb future shocks as a result of the erosion of fiscal buffers, ocassioned by the COVID-19 pandemic, and relatively weaker economic resilience, reflecting the less diversified economy. The revision of the outlook reflects broadly balanced risks, continued strong financial position despite downside risks to the post-pandemic fiscal consolidation path, low political risk, prudent policy making, limited risks pertaining to government liquidity and external vulnerability. The ratings could be revised upwards if there is improved resilience to shocks, reduced vulnerability of the budget structure and notable progress on economic diversification.

Box 3: Reforms to Monetary Operations Framework

The Bank continues to monitor developments in money market liquidity conditions and evaluate monetary policy implementation framework on a regular basis for effectiveness and enhancements where necessary. Reforms to the monetary operations framework, in particular, changes to the anchor policy rate and interest rate structure aimed at strenthening the monetary policy transmission mechanism remain work in progress, while awaiting the final recommendations to the just ended IMF Technical Assistance mission (April 2021).

Furthermore, the introduction of the Primary Reserve Requirement Averaging (PRRA) in 2019, has helped commercial banks to effectively manage liquidity, and the Bank envisages that this will, over time, lead to reduced desire to hold excess reserves by commercial banks for precautionary purposes, thus freeing up additional resources for productive lending.

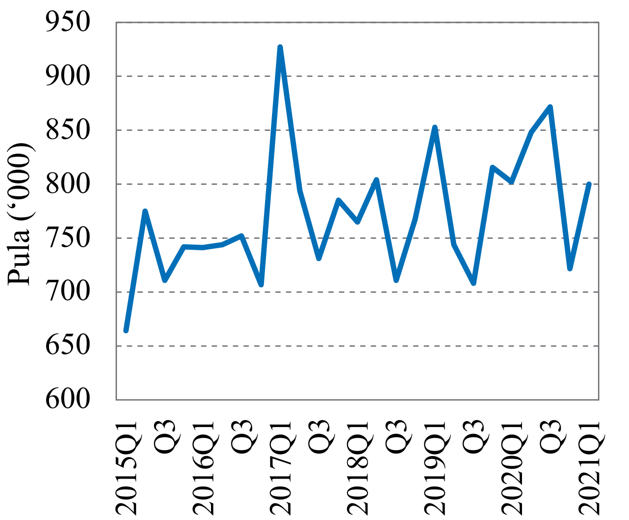
3.5 Asset markets

Property market generally improved in the first quarter of 2021

According to the latest (2021Q1) Riberry Report[1], the residential rental market improved in the first quarter of 2021, compared to the fourth quarter of 2020, due to good rental market for the lower-end properties in terms of both demand and supply.

The average price for residential properties sold in the first quarter of 2021 increased by 11.1 percent to P800 000 compared to the previous quarter (Chart 3.12), reflecting the higher number of high valued properties traded in the quarter under review. Looking ahead, the demand for lower-end, medium and prime located residential housing is expected to improve further given the affordability of properties in these categories compared to those in the upper-end market.

Chart 3.12: Riberry Average Prices



The market for office space remains weak due to increasing supply from completed construction developments, such as the Botswana Unified Revenue Service building at the Gaborone Central Business District (CBD). However, demand remains weak and uncertain due to COVID-19 and generally subdued business conditions. Despite the negative impact of the pandemic and generalised weak demand for office space, there has been continued good office enquiries and/or uptake in the CBD and Showgrounds. Going forward, there is a possible likelihood for a slowdown in uptake at the CBD, especially due to COVID-19 particularly if Government institutions remain in their current premises and location. In addition, the supply of office space is likely to increase further, given the ongoing construction projects and planned office buildings at the CBD, such as by the Botswana Housing and Water Utilities Corporations. These will further exert downward pressure on rentals, especially in the decentralised office locations.[2] Furthermore, the outbreak of COVID-19 has resulted in most companies allowing their employees to work from home, and this could negatively affect the demand for office space.

Similar to the previous quarter, the demand for retail space remains fair across all market segments, while the supply is expected to increase on completion of the ongoing construction of a major shopping centre in the CBD, while another one is

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

[2] 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 Shopping Mall, cost P75/m2, while prime industrial areas like Gaborone International Commerce Park cost P65/m2.

proposed for Mogoditshane. In addition, other centres with good demand for retail space are Jwaneng, Lobatse, Selibe Phikwe, Maun, Francistown, Mahalapye and Letlhakane. This is because most of these locations have a few retail schemes at planning and/or construction stage and are to be anchored by reputable supermarkets. With regard to industrial property, the supply of unoccupied big warehouse space has decreased, while the demand has improved.[3] Meanwhile, the availability of prime location industrial space is expected to decrease going forward, given that most of the centrally located industrial land is almost fully developed and occupied.

Domestic Companies Index declines

The Domestic Companies Index (DCI) declined by 5.5 percent in the twelve months to July 2021 compared to a reduction of 6.5 percent in the year to July 2020 (Chart 3.13). The decline was mainly due to the lower share prices for Turnstar and Sechaba which fell by 29 percent and 24.5 percent, respectively, in the same period.

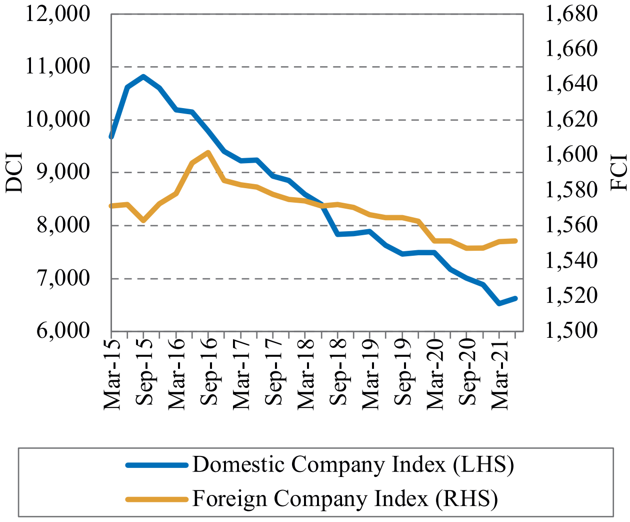
According to Stockbrokers Botswana, the sustained decline in the DCI was reflective of the low trading activity and liquidity, as well as sluggish corporate earnings due to the restrained economic environment.

Foreign Companies Index increases

The Foreign Companies Index (FCI) increased slightly by 0.1 percent in the year to July 2021, compared to a decline of 0.9 percent in the corresponding period ending in July 2020 (Chart 3.13). This was largely attributed to the year-on-year increase in the share price for Tlou (56.3 percent), New Platinum (36.8 percent) and New Funds (22.7 percent) on account of improved trading activity and liquidity.

[3] Investors prefer bigger warehouses, but available warehouse space is limited.

Chart 3.13: Stock Market Indices



Source: Botswana Stock Exchange

3.6 Balance of payments (BoP)

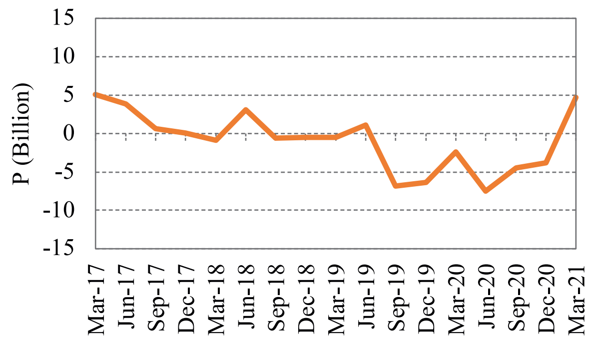
Current account records a surplus in the first quarter of 2021

The current account is estimated to have recorded a surplus of P4.7 billion in the first quarter of 2021, compared to a revised deficit of P2.4 billion during the corresponding period in 2020 (Chart 3.14). The surplus is attributable to the positive balance of P2.1 billion in the merchandise trade account and P5.7 billion in the secondary income account, the latter being dominated by the Southern African Customs Union (SACU) revenue receipts. Total exports increased by 82.6 percent from P13.2 billion to P24.1 billion, while imports increased by 31.7 percent from P16.7 billion to P22 billion, leading to a surplus of P2.1 billion in the merchandise trade account.

Diamond exports, which accounted for 93.7 percent of total exports of goods in the first quarter of 2021, increased from P11.4 billion in the first quarter of 2020 to P22.6 billion in the first quarter of 2021. During the same period, diamond imports increased from P3.5 billion to P9.1 billion. The increase in diamond trade mainly resulted from recovery in demand for diamond jewellery in the US and China.

The other commodities that contributed to the increase in exports include gold (25.1 percent), plastic and plastic products (24.7 percent), and iron and steel products (19 percent). Commodities that contributed to the increase in imports are metal and metal products, chemical and rubber products, and textiles and footwear that increased by 38.1 percent, 25.8 percent, and 13.5 percent, respectively.

Chart 3.14: Quarterly Current Account Balance



Source: Bank of Botswana

The financial account records a surplus in the first quarter of 2021

The financial account registered an estimated surplus of P2.4 billion during the first quarter of 2021, compared to a revised deficit of P3.4 billion in the first quarter of 2020. The surplus was mainly attributable to an increase in offshore investments, particularly by pension fund managers.

The balance of payments in deficit in the first quarter of 2021

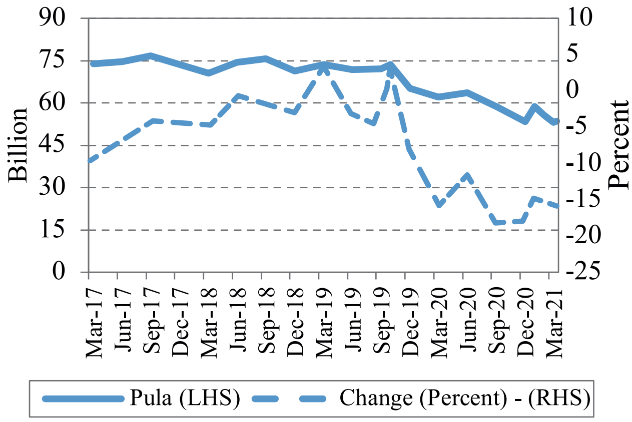
The overall BoP was in deficit by P904.3 million during the first quarter of 2021, compared to a deficit of P4.9 billion during the corresponding period in 2020. The deficit mainly resulted from financing government obligations, such as payments for imports, external loan servicing and funding of embassies.

Foreign exchange reserves decrease

As at the end of May 2021, foreign exchange reserves amounted to P51 billion, a decrease of 22.8 percent from P66.1 billion in May 2020 (Chart 3.15). The decrease was due to drawdowns to finance government obligations.

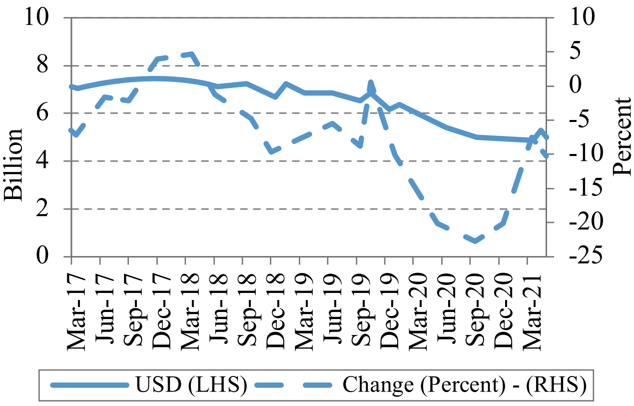
In foreign currency terms, the level of reserves decreased by 14.3 percent from USD5.6 billion in May 2020 to USD4.8 billion in May 2021 (Chart 3.16). The reserves also decreased by 19.5 percent from SDR4.1 billion to SDR3.3 billion in the same period. The level of reserves as at the end of May 2021 was equivalent to 9.6 months of import cover of goods and services.

Chart 3.15: Foreign Exchange Reserves in Pula and Annual Percentage Change



Source: Bank of Botswana

Chart 3.16: Foreign Exchange Reserves in US Dollars and Annual Percentage Change



Source: Bank of Botswana

3.7 Exchange rate developments

For 2021, the implementation of the exchange rate policy by the Bank entailed the maintenance of an annual downward rate of crawl of 2.87 percent (Box 4). This downward rate of crawl was implemented from May 1, 2020[4] with a view to enhance domestic industry competitiveness in response to the adverse impact of the COVID-19 pandemic on the economy. The Pula basket weights were also maintained at 45 percent for the South African rand and 55 percent for the SDR, guided by Botswana's trade pattern and international transactions.

Bilaterally, the Pula depreciated against the South African rand by 9.5 percent but appreciated against

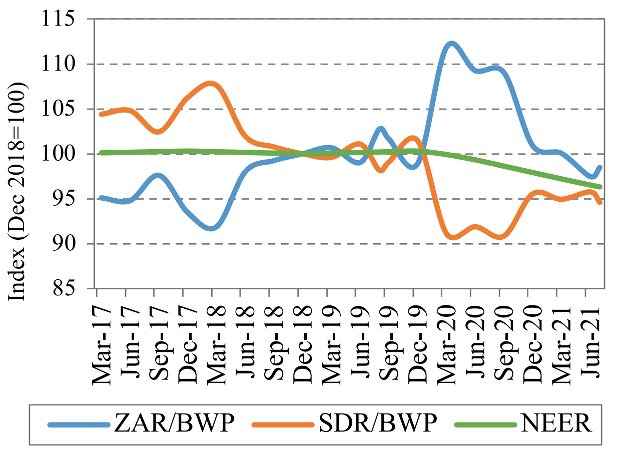
[4] Effective May 2020, the Bank implemented an annual downward rate of crawl of 2.87 percent. This was complementary to the reduction in the Bank Rate in April 2020 and contributed to further easing of real monetary conditions to help promote domestic economic activity.

the SDR by 3 percent in the twelve months to July 2021 (Chart 3.17). Against the SDR constituent currencies, the Pula appreciated by 9.2 percent against the Japanese yen, 4 percent against both the US dollar and the euro, while it depreciated against the Chinese renminbi and British pound by 3.9 percent and 2.1 percent, respectively.

The movement of the Pula against the SDR constituent currencies largely reflects the performance of the South African rand against the SDR constituent currencies. Notably, in the same review period, the South African rand appreciated by 13.8 percent against the SDR. With respect to the SDR constituent currencies, the South African rand appreciated by 20.6 percent against the Japanese yen, 14.9 percent against both the US dollar and the euro, 8.1 percent against the British pound and 6.2 percent against the Chinese renminbi.

The South African rand strengthened against most of the major trading currencies as the external environment continues to be supportive to the South African rand due to rising commodity prices which have provided support to South Africa's significant raw material and precious metal export sector, thus boosting the country's trade balance. Moreover, the South African rand, along with other emerging markets currencies, strengthened amid reassurances by the US Federal Reserve Bank that it will not exit its monetary policy stimulus in the near term. Riskier and high yielding emerging market assets, such as the rand, benefit from low interest rates in the US due to the investors' tendency to borrow in a low yielding currency and invest in higher yielding assets.

Chart 3.17: Nominal Exchange Rate Indices

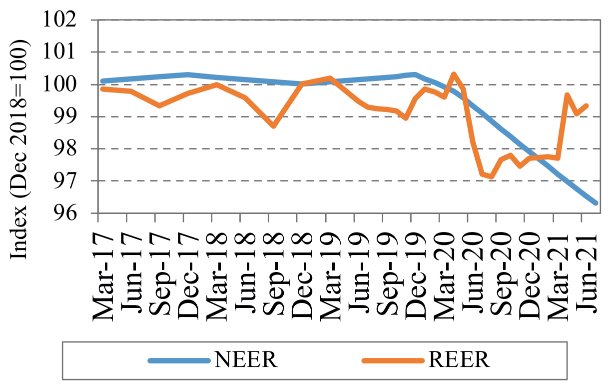


Source: Bank of Botswana

NEER depreciated in July 2021

The NEER of the Pula depreciated by 2.81 percent in the twelve months to July 2021 (Chart 3.18), consistent with the downward annual rate of crawl of 2.87 percent implemented effective May 2020.

Chart 3.18: Nominal and Real Effective Exchange rates



Source: Bank of Botswana

REER appreciated in June 2021

The REER appreciated by 1.1 percent in the twelve months to June 2021 (Chart 3.18), because of a higher positive inflation differential (4.1 percent) between Botswana and the trading partner countries than the downward rate of crawl (2.8 percent). With respect to bilateral movements against the Pula basket currencies, the real Pula exchange rate (using headline inflation) depreciated by 8 percent against the South African rand but appreciated by 9.3 percent against the SDR. Against the SDR constituent currencies, the local currency appreciated by 19.7 percent against the Japanese yen, 10.9 percent against the US dollar, 8.1 percent against the euro, 5.7 percent against the Chinese renminbi and 1.1 percent against the British pound.

Box 4: Botswana's Exchange Rate Framework

The Exchange Rate Policy

Botswana's exchange rate policy aims to maintain a stable REER to support competitiveness of domestic industry in the international and domestic markets. By extension, the policy supports the national objective of economic diversification, together with the associated industrial development and employment creation objectives. The Pula exchange rate is determined based on a peg to a basket of currencies, the choice of which is guided by the trade pattern and currencies used in international trade and payments. It is pegged to a trade-weighted basket of currencies that comprise the South African rand and the IMF's unit of account, the SDR. Pegging to a basket of currencies, rather than a single currency, means that movements in the Pula exchange rate are not subject to an extreme influence of exceptional volatility of any single currency.

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

Current Exchange Rate Framework

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

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

4. THE ECONOMIC AND POLICY OUTLOOK

4.1 Global economic prospects

The global economic outlook for 2021 is unchanged in the July 2021 WEO Update, but with offsetting revisions for the regions. Prospects for advanced economies are much stronger compared to emerging market economies, owing to expectations of widespread vaccine availability and additional fiscal support particularly in the US. Regionally, in South Africa, the growth outlook is projected to improve, mainly due to the relaxation of movement restriction measures and rollout of effective COVID-19 vaccines. With regard to price developments, global inflation is forecast to increase to 3.5 percent in 2021 from 3.2 percent in 2020, consistent with the anticipated rise in international oil prices and recovery in global demand as most countries deploy effective COVID-19 vaccines.

Global economic activity to expand
According to the July 2021 WEO Update, global output growth is forecast at 6 percent and 4.9 percent in 2021 and 2022, respectively, from an estimated contraction of 3.2 percent in 2020. The growth forecast for 2021 is unchanged from the April 2021 WEO projections, but with offsetting revisions across the regions: growth forecast for advanced economies has been revised upwards but downwards for emerging market economies, reflecting pandemic developments and changes in policy support. However, growth forecast for 2022 has been revised upwards by 0.5 percentage points from the April 2021 WEO, mostly reflecting additional policy support in advanced economies, such as the US, as well as anticipated widespread availability of effective COVID-19 vaccines. Similar to the April 2021 projections, all regions are projected to experience positive growth in 2021.

For advanced economies, output growth is forecast to expand by 5.6 percent in 2021, from a contraction of 4.6 percent in 2020. The 2021 projection is an improvement by 0.5 percentage points from the April 2021 WEO, mostly reflecting expected further normalisation in the second half of 2021 boosted by the anticipated additional fiscal support particularly in the US as well as successful rollout of effective COVID-19 vaccines. The anticipated legislation on infrastructure investment and strengthening of social safety nets in the second half of the year are expected to stimulate the US's economic activity.

Risks to the global economic outlook are assessed to be on the downside. These include slower-than-anticipated vaccine rollouts that could allow the virus to mutate further, tightening financial conditions particularly in advance economies to control inflation, worsening pandemic dynamics and tighter external financial conditions that could setback recovery in emerging market economies and drag global growth below its outlook's baseline.

UK economy to expand in 2021
The UK economy is expected to grow by 7 percent in 2021, compared to a contraction of 9.8 percent in 2020 and 1.7 percentage points higher compared to the April 2021 forecast, supported by the COVID-19 vaccination programme that is expected to ease movement restrictions. In addition, the already announced fiscal and monetary policy actions, such as additional spending and asset purchases programme are expected to boost economic activity in the same period. Economic activity is forecast to expand by 4.8 percent in 2022, supported in part by policy stimulus.

Output growth for US to expand
For the US, output is forecast to grow by 7 percent in 2021, before expanding by 4.9 percent in 2022, from an estimated contraction of 3.5 percent in 2020. The 2021 and 2022 projections are upward revisions by 0.6 percentage points and 1.4 percentage points, respectively, compared to the April 2021 forecast. The revisions reflect the fiscal support of USD1.9 trillion coronavirus stimulus package, which was signed into law in March 2021.

Growth for the euro area to expand
In the euro area, economic activity is projected to expand by 4.6 percent in 2021 (0.2 percentage points upgrade compared to the April 2021 WEO) from a decline of 6.5 percent in 2020. The upward

revision of growth prospects in the economic bloc for 2021 reflects gains in momentum of vaccination campaigns, subsiding pressure on health systems and gradual relaxation of containment measures. Strengthening momentum is expected in France, Germany, Italy and Spain in the second half of the year and anticipated to carry over into 2022. Thus, GDP for the region is forecast to increase by 4.3 percent in 2022, an upward revision from the 3.8 percent projection made in April 2021.

Emerging markets GDP expansion projected to be higher

Economic activity in emerging market and developing economies is projected to expand by 6.3 percent in 2021, from an estimated contraction of 2.1 percent in 2020. The 2021 economic performance has been revised downwards by 0.4 percentage points relative to the April 2021 WEO. The revision was primarily due to emergence of new variants of the COVID-19 virus particularly in India from March to May 2021, weighing on the country's economic recovery. Furthermore, the downward revision was on account of China's scaling back of public investment and overall fiscal support which resulted in the country's downward revision by 0.3 percentage points to 8.1 percent growth in 2021.

Nonetheless, economic prospects for China remain stronger than for most countries in the region, supported by effective containment measures, a forceful public investment response and central bank liquidity support, hence a forecast expansion of 8.1 percent and 5.7 percent for 2021 and 2022, respectively. Similarly, India is forecast to grow by 9.5 percent and 8.5 percent in 2021 and 2022, respectively, reflecting the easing of lockdowns and other movement restrictions put in place to combat the spread of the virus.

Growth in the South African economy to expand

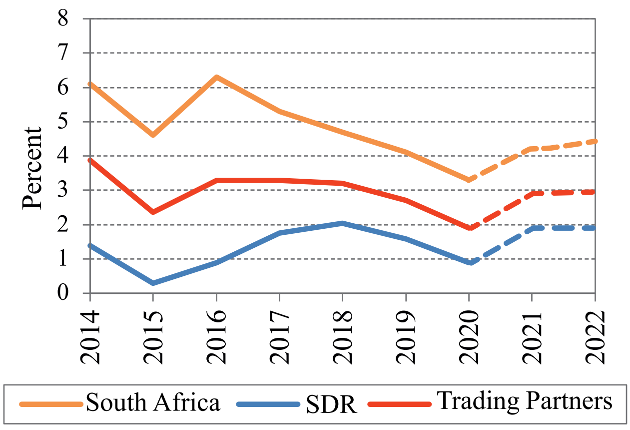
Growth prospects in South Africa are expected to improve on account of rollout of effective COVID-19 vaccines, supportive global economic activity as well as robust terms of trade and stronger exports. Therefore, South African output is forecast to expand by 4 percent and 2.2 percent in 2021 and 2022, respectively, from a contraction of 7 percent in 2020. Meanwhile, in July 2021, the SARB left the GDP growth forecast for 2021 unchanged at 4.2 percent on account of estimation of the recent unrest (violent protests and looting over former President Jacob Zuma's arrest) to have fully negated the better growth results from the first quarter. However, the unrest and economic damage could have lasting effects on investor confidence and job creation, and likely to further slow South Africa's economic recovery. Growth is forecast at 2.3 percent and 2.4 percent in 2022 and 2023, respectively, also unchanged since the May 2021 MPC meeting.

Global inflation to increase

Globally, inflation is expected to pick up in 2021, owing to recovery in commodity prices, particularly oil, as well as global demand as most economies ease movement restrictions and deploy effective COVID-19 vaccines. Inflationary pressures are expected to mount in advanced economies relative to other regions, reflecting the faster rollout of COVID-19 vaccines, particularly in the UK and US. Thus, inflation for advanced economies is forecast to increase from 1 percent in 2020 to 2.4 percent in 2021. For emerging market economies, inflation is forecast to increase slightly from 3.1 percent to 5.4 percent in the same period, as the region continues to face greater constraints in procurement and distribution of COVID-19 vaccines. Overall, global inflation is forecast to increase from 3.2 percent in 2020 to 3.5 percent in 2021.

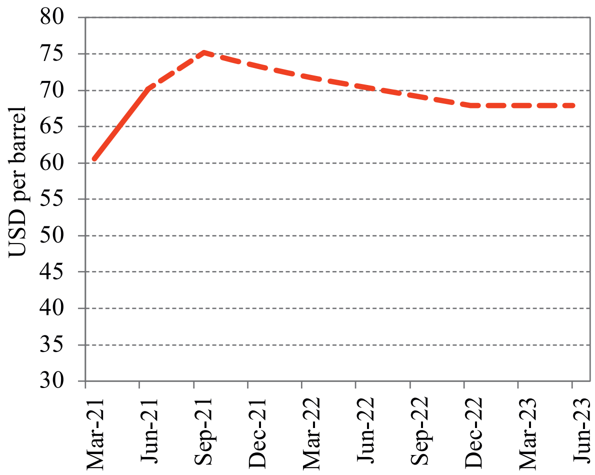
Meanwhile, South African inflation is forecast to average 4.3 percent in 2021, 0.1 percentage points higher than the May 2021 forecast by SARB, reflecting anticipated recovery in domestic economic activity amidst the easing of lockdown restrictions and rollout of COVID-19 vaccines. However, the forecast for 2022 was revised lower to 4.2 percent from 4.4 percent but was unchanged at 4.5 percent for 2023. Overall, inflation is anticipated to remain within the SARB's target range between 2021 and 2023, rising to the midpoint of the target range in 2023 (Chart 4.1).

Chart 4.1: South Africa and SDR Headline Inflation



Source: SARB and Bloomberg

Chart 4.2: International Oil Prices



Source: Bloomberg

Global commodity prices to increase

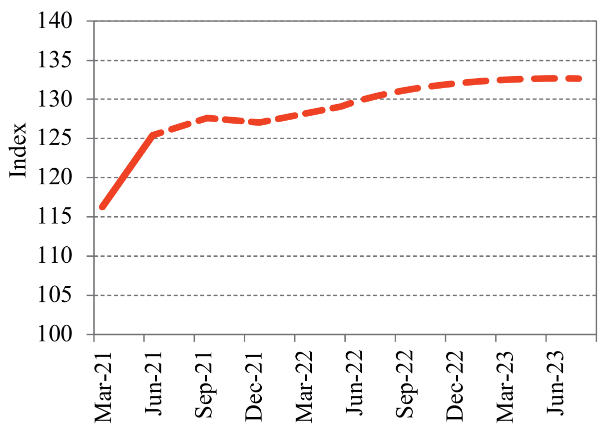
Global rough diamond prices are expected to increase in the short to medium term, buoyed by rollout of effective COVID-19 vaccines. In addition, the easing of lockdowns and other containment measures are anticipated to continue to strengthen demand for jewellery, thus exerting inflationary pressure on rough diamond prices. Likewise, polished diamond prices are expected to rise in the short to medium term as prospects for global end-consumer demand improve.

In addition, international oil prices are projected to increase in the short term, (Chart 4.2), supported by the recovery in global demand following the relaxation of some COVID-19 containment measures and effective rollout of vaccines in many countries. Furthermore, positive developments on the economic front, supported by stimulus programmes, are expected to boost the demand for oil in 2021. Meanwhile, the decision by OPEC and major oil producers to continue with production cuts to prevent the market from being oversupplied, as well as the fall in oil inventories, particularly the US shale oil, are expected to exert upward pressure on international oil prices. Overall, developments in the international oil market imply marginal upward pressure on domestic inflation in the short term.

Global food prices are also expected to trend upwards in the short to medium term (Chart 4.3). The expected increase in food prices mainly reflects the increased demand and cost-push pressures arising from supply disruptions caused by lockdowns and other containment measures that have reduced production hours and constrained the flow of goods. The projection of higher food prices in the short term also reflects the rising oil prices. The COVID-19 pandemic has led to strong demand for basic food items, posed logistical challenges in harvesting and reduced supply.

In Southern Africa, food prices are expected to increase in the short term due to anticipated lower crop production resulting from bad climatic conditions caused by tropical Cyclone Chalane and Eloise. Overall, there is potential modest upward pressure from international food prices on domestic inflation in the short term.

Chart 4.3: International Food Prices FAO Index



Source: Bloomberg

4.2 Outlook for domestic economic activity

Projections by MFED indicate that GDP growth will rebound to 8.8 percent in 2021, from a contraction of 8.5 percent in 2020. The economy is anticipated to continue operating below its potential into the medium term, with recovery supported by the prevailing accommodative monetary conditions, improvements in water and electricity supply, reforms to further improve the business environment and government interventions against COVID-19, including vaccine rollouts, the implementation of the ERTP and the Industry Support Facility, among others. Notwithstanding prospects of a recovery in 2021, many of the risks that prevailed in 2020 remain in place, although less pronounced.

Higher output growth expected in 2021

MFED projects that GDP will expand by 8.8 percent in 2021, from a contraction of 8.5 percent in 2020, in part, reflecting improving global economic prospects and balanced risks. Meanwhile, the IMF forecasts the domestic economy to rebound to 8.3 percent in 2021. The positive outlook for economic activity is anticipated to continue beyond 2021, albeit below trend, and supported by the prevailing accommodative monetary conditions, improvements in water and electricity supply, reforms to further improve the business environment, government interventions against COVID-19, including vaccine rollouts, the implementation of the ERTP and the Industry Support Facility, among others. Notwithstanding prospects of a recovery in 2021, many of the risks that prevailed in 2020 remain in place, although less pronounced. Box 5 outlines Bank of Botswana's response to COVID-19.

The Bank's June 2021 Business Expectations Survey (BES) indicates that firms were less pessimistic about economic activity in the second quarter of 2021 compared to the previous quarter. The optimism partly arises out of the expected gradual easing of the COVID-19 movement restrictions. Firms expect GDP to expand by 3.2 percent in the second quarter of 2021, consistent with the anticipated improvement in business conditions and the envisaged global economic recovery in 2021. Overall, non-mining economic activity is anticipated to improve in the short term although continuing to operate below potential into the medium term.

Box 5: Bank of Botswana's response to the impact of COVID-19 pandemic

Botswana confirmed its first three imported cases of COVID-19 on March 31, 2020. As at August 10, 2021; 136 758 total local cases (121 987 local recoveries, 12 798 local active cases and 1973 local deaths) were reported in the country. To curb the spread of the disease, the country was put on a 28-day lockdown (extreme social distancing) effective from midnight of April 2, 2020, with movement outside the home only restricted to essential goods and service providers. On April 9, 2020, Parliament approved His Excellency the President's request for a six-month State of Emergency (SOE), which was extended by six months to April 2021 and later by another six months to September 2021, to allow the country to adequately respond to the threat posed by COVID-19. Meanwhile, on March 26, 2021, Botswana started its COVID-19 vaccination programme, with priority given to people aged 55 years and above. Effective July 22, 2021, the vaccination rollout programme transited to cover phase two category (specifically those aged 45 to 54). By August 10, 2021, a total of 245 061 people had received a first vaccine dose and 146 299 people were fully vaccinated across the country.

For its part, the Bank of Botswana (the Bank) has undertaken measures to alleviate the adverse impact of COVID-19 on the Botswana economy, such as maintaining uninterrupted supply and availability of clean banknotes and coins, as well as banking services, primarily to Government and commercial banks. On the other hand, in an attempt to support the banking system, the Bank offered capital relief and support measures for commercial banks to enable them to satisfy capital requirements and address liquidity challenges as they continue to support economic activity under conditions of a possible increase in credit risk. In this regard, effective April 2020, the Bank adopted the following measures:-

- The prudential capital adequacy ratio (CAR) for commercial banks operating in Botswana was reduced from 15 percent to 12.5 percent; and
- To alleviate any liquidity pressures on commercial banks, the following measures were introduced:
  - The cost of accessing overnight funding by licensed commercial banks from the Bank's Credit Facility is accessed at the prevailing Bank Rate (currently 3.75 percent) without the punitive 6 percentage points above the Bank Rate;
  - The Primary Reserve Requirement was reduced from 5 percent to 2.5 percent of total deposit liabilities;
  - Repo facilities, which were available only on an overnight basis are offered against eligible securities with maturities of up to 92 days; and
  - Subject to completing regulations and arrangements relating to valuation and custody, the collateral pool for borrowing by licensed commercial banks from the Bank will be extended to include corporate bonds listed and traded on the Botswana Stock Exchange.

Other measures to help the economy included reducing the Bank Rate by a cumulative 100 basis points in 2020 to 3.75 percent.

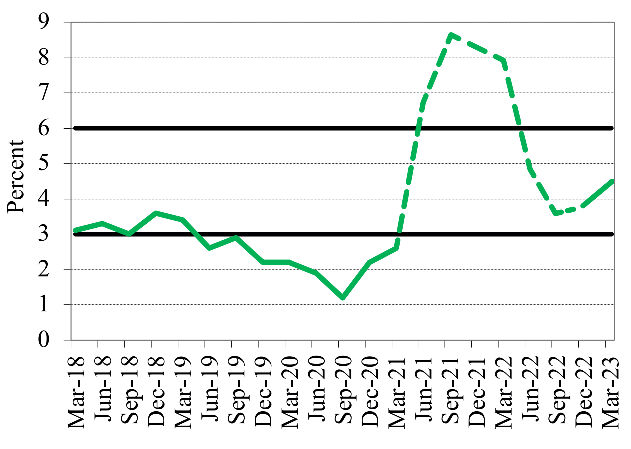
4.3 Monetary policy and the inflation outlook

Inflation is forecast to remain above the upper bound of the Bank's 3 - 6 percent objective range in the short term. Nonetheless, inflation is expected to revert to within the desired objective range of 3 - 6 percent in the second quarter of 2022. Compared to the June 2021 forecast, inflation is projected to be slightly higher in the short term, mainly reflecting the upward revision in forecasts for trading partner countries inflation and international commodity prices, as well as the improvement in the domestic economic activity in the first quarter of 2021 than had been previously projected. However, the current inflation projection is lower in the medium term, on account of the base effects associated with the upward adjustments in VAT and administered prices in 2021 being more pronounced due to second-round effects, as well as the downward revision in South African inflation and the expected appreciation of the Pula against the rand in the medium term. Overall, risks to the inflation outlook are assessed to be skewed to the upside.

Inflation is projected to be higher in the near term

Inflation is projected to remain above the upper bound of the objective range in the short term. Nonetheless, inflation is expected to revert to within the objective range in the second quarter of 2022 (Chart 4.4), mainly on account of the dissipating impact from the inflation calculation of the upward adjustment in VAT and administered prices in the first half of 2021.

Chart 4.4: Botswana Headline Inflation Forecast



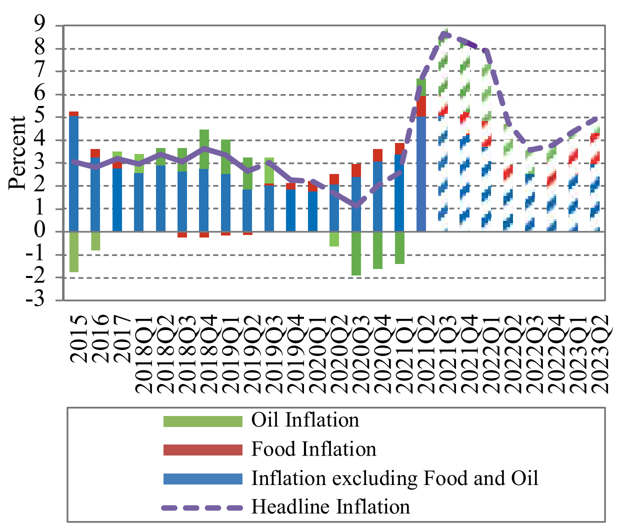
Source: Bank of Botswana

The projection takes into account the anticipated increase in domestic demand in response to the overall accommodative monetary conditions; the recent increase in domestic fuel prices; the expected increase in electricity tariffs by 5 percent in 2022; the revision in forecasts for trading partner countries inflation; the likely increase in international commodity prices; the anticipated appreciation of the Pula against the South African rand in the medium term; and the base effects associated with adjustments in VAT and administered prices in 2021. The increase in domestic fuel prices from July 10, 2021 is expected to add approximately 0.62 percentage points to inflation in the third quarter of 2021, while the rise in electricity tariffs in 2022 is expected to add 0.27 percentage points to inflation in the second quarter of 2022. Meanwhile, according to the June 2021 BES, the businesses maintained their expectation that inflation would remain within the Bank's medium-term objective range of 3 – 6 percent in 2021.

Core inflation to increase in the short term

Inflation excluding food and fuel prices is forecast to increase in the short term, mainly reflecting the increase in administered prices and the expected improvement in non-mining output growth (Chart 4.5).

Chart 4.5: Headline Inflation and its Components

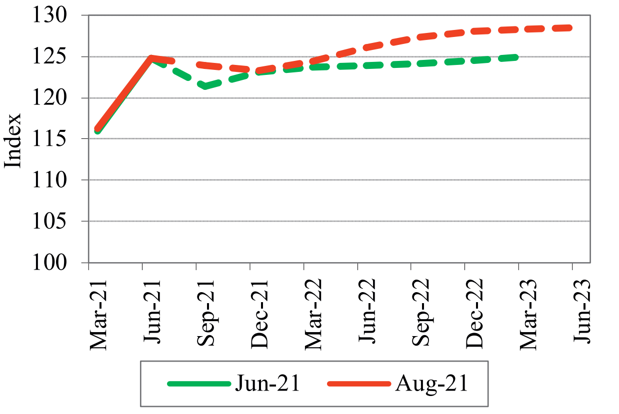


Source: Bank of Botswana

International food prices to increase

Compared to the June 2021 forecast, international food prices have been revised upwards in the short to medium term (Chart 4.6). The upward revision reflects increased demand and cost-push pressures arising from supply disruptions caused by lockdowns and other containment measures that have reduced production hours and constrained the flow of goods. The revision is also supported by the recovery in global demand following the relaxation of some COVID-19 containment measures, higher energy costs and the anticipated lower crop production resulting from bad climatic conditions in some regions.

Chart 4.6: International Food Prices
FAO Index

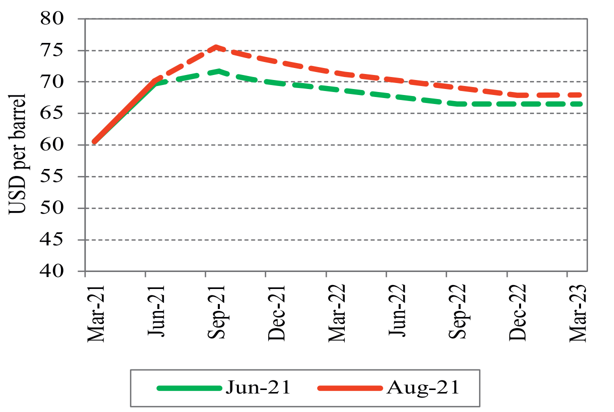


Source: Bloomberg

International oil prices revised upwards

Relative to the June 2021 projection, international oil prices have been revised upwards in the short to medium term (Chart 4.7). The upward revision in prices is due to the expected recovery in global oil demand following the relaxation of some COVID-19 containment measures amid rollout of vaccines, stimulus programmes around the world, the continued production cuts by OPEC and major oil producers, as well as the fall in oil inventories.

Chart 4.7: International Oil Prices



Source: Bloomberg

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

Inflation forecast revised upwards in the short term

Compared to the June 2021 forecast, inflation is projected to be slightly higher in the short term, mainly due to the upward revision in forecasts for trading partner countries' inflation and international commodity prices, as well as the improvement in the domestic economic activity in the first quarter of 2021 than previously projected. However, the current inflation projection is lower in the medium term due to the downward revision in South African inflation and the expected appreciation of the Pula against the rand in the medium term.

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 South African rand and the SDR constituent currencies against each other, and their relative weights in the composite currency basket.

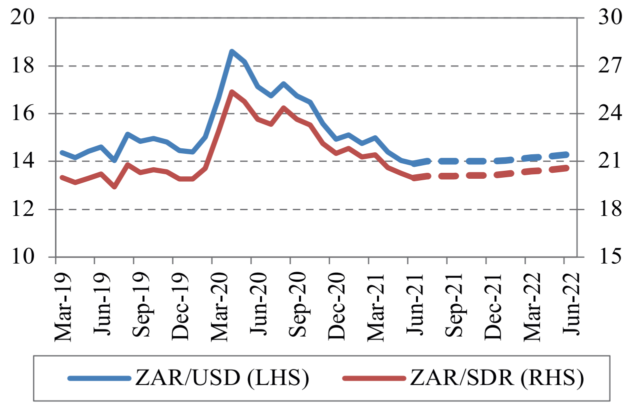
The South African rand is expected to depreciate against all major trading currencies in the next four quarters (Chart 4.8), as the country officially declared the third wave of COVID-19 infections with new infections mainly dominated by the highly infectious Delta variant. The outbreak of the new variants poses concerns of possible reinforcement of restrictive measures in the country to cope with the speed and the scale of such variants. Moreover, the recent civil unrest in South Africa, which has led to lootings and burning of commercial and business properties, including shopping malls, warehouses and pharmacies, will derail South Africa's COVID-19 vaccination distribution and efforts to rebuild the economy in the wake of the pandemic. This is on the backdrop of weak macroeconomic fundamentals[5], power supply constraints and highly indebted state-owned enterprises. Meanwhile, monetary policy

[5] Weak economic growth, high budget deficit and high public debt.

developments in the US are expected to continue influencing the performance of the South African rand.

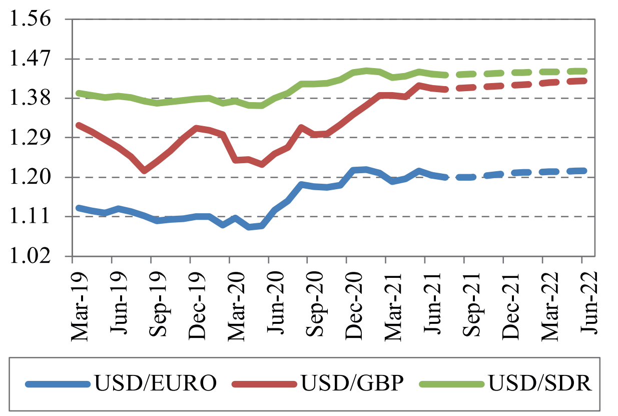
However, the external environment remains favourable to the South African rand due to rising commodity prices which have provided support to South Africa's significant raw material and precious metal export sector, supporting the country's trade balance.

Chart 4.8: ZAR against USD and SDR



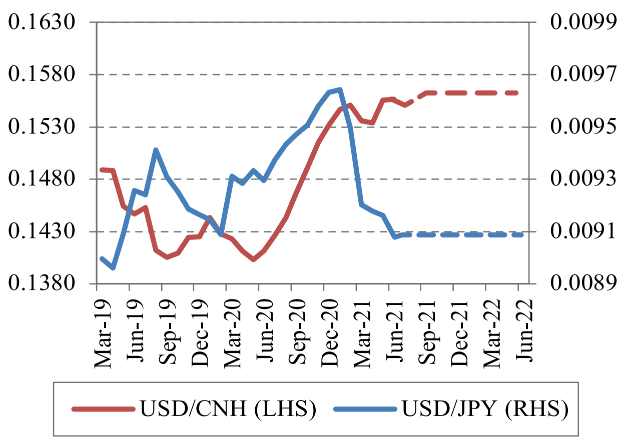
Source: Reuters

Chart 4.9A: Exchange Rates against USD



Source: Reuters

Chart 4.9B: Exchange Rates against the USD



Source: Reuters

The US dollar is expected to slightly depreciate against major international currencies in the next four quarters (Chart 4.9A and Chart 4.9B), as global investors are cautiously focused on monetary policy developments in the US. The Fed recently highlighted that current price increases are due to economic reopening and are transitory, therefore interest rate hikes are not yet considered. Therefore, the present situation of ultra accomodative monetary policy, high inflation rates, as well as negative interest rates is driving investors away from the US dollar. However, global uncertainty and market volatilty due to the surge in COVID-19 infections and uneven vaccination rollout in emerging market countries is likely to influence investors to hold safe haven assets, such as the US dollar, thus affecting this forecast.

The British pound is expected to strengthen against the US dollar as the BoE indicated that if downside risks to growth and inflation do not rise significantly, then it may appropriately withdraw some monetary policy stimulus earlier than initially anticipated, including the ongoing quantitative easing program. Moreover, the BoE signalled that the rapid rollout of UK's vaccination programme has led to an improvement in the country's economic outlook. Meanwhile, the euro is expected to appreciate against the US dollar as the new ECB monetary policy framework[6] is expected to support the euro in the near term. This new framework is anticipated to advantage the euro since it comes at a time when the public health situation in the area is improving and vaccination campaigns are at full speed.

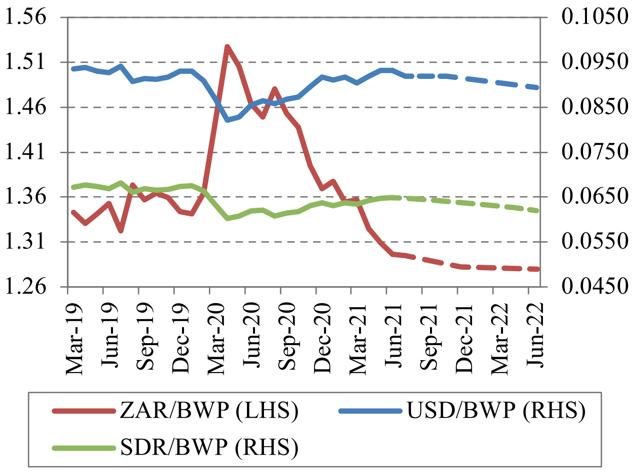
The Japanese yen is expected to remain relatively stable against the US dollar due to its safe haven status as the spread of the highly contagious Delta variant threatens the complete opening of the global economy.

The Chinese renminbi is expected to appreciate against the US dollar in the next four quarters (Chart 4.9B) as China's strong export sector is expected to drive economic growth in the second half of the year. However, the recovery in goods supply in both the US and the Euro area is likely to adversely affect China's exports growth, consequently affecting this forecast.

[6] The ECB announced a new strategy that allows inflation to go higher than its new 2 percent symmetric target.

Overall, forecast movements of the SDR constituent currencies imply a marginal appreciation of the SDR against the US dollar (Chart 4.9A). The anticipated depreciation of the South African rand against the SDR is, however, expected to exert downward pressure on the Pula against the SDR constituent currencies in the forecast horizon (Chart 4.10). However, the Pula is expected to depreciate against the South African rand in the next four quarters due to the cumulative effect of the downward rate of crawl. The expected depreciation of the Pula against the basket currencies will exert upward pressure on domestic inflation.

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



Source: Reuters and BoB calculations

Risks are skewed to the upside

Overall, risks to the inflation outlook are assessed to be skewed to the upside. These risks include the potential increase in international commodity prices beyond current forecasts; persistence of supply constraints due to possible maintenance of travel restrictions and lockdowns; and domestically-based risk factors relating to second-round effects of the recent increases in administered prices and inflation expectations that could lead to generalised higher prices. Furthermore, aggressive action by governments (for example, the ERTP) and major central banks to bolster aggregate demand, as well as the successful rollout of the COVID-19 vaccination programmes could add pressure to inflation. However, these risks are moderated by the possibility of weak domestic and global economic activity, with a likely further dampening effect on productivity due to periodic lockdowns and other forms of restrictions in response to the emergence of new COVID-19 variants. A slow rollout of vaccines resulting in the continuance of weak economic activity and the possible decline in international commodity prices could also result in lower inflation, as would any capacity constraints in implementing the ERTP initiatives.

Box 6: Central Bank Communication on Monetary Policy

The last three decades bear witness to central banks progressively using public communication to support their policy objectives as well as enhance transparency in the formulation and implementation of effective monetary policy (Robison, 2020). The change has been necessitated by the growing recognition that central bank communication enhances both the transmission of monetary policy and the management of inflation expectations, which are fundamental to effective monetary policy.

As noted by Kahveci and Odabas (2016), the post-crisis transmission in central bank policy from mystery and inscrutability to the era of transparency, as well as the importance of 'forward-guidance' demonstrate how rapidly and radically the communication strategy has evolved. Evidently, communication has become a policy tool in its own right. Central bank communication, as defined by Blinder et al. (2008), is the information that the central bank makes available about its current and future policy objectives, current and prospective economic developments pertaining to key policy variables including inflation and output, risks to the inflation outlook and the likely path for future monetary policy decisions. Furthermore, the central bank communicates the rationale for its policy decisions.

The shift towards greater transparency is generally viewed as desirable in so far as it enhances effectiveness of monetary policy in anchoring economic agent's expectations for future policy changes, safeguarding independence, and legitimacy of central banks against the backdrop of enlarged mandates and greater public scrutiny. Furthermore, greater transparency increases predictability, accountability, and credibility of central banks.

The Bank of Botswana (the Bank), like most other central banks, recognises the importance of communication in sustaining and reinforcing transparency, predictability, and accountability with respect to the policy framework and actions; thus, fostering market participation, influencing expectations, policy credibility and, consequently, policy transmission. The Bank's communication function has evolved with the establishment of the Communications and Information Services Division, which deals with media relations, public education, the Knowledge Centre (Library), administration of the Bank's website (dissemination of Bank's information) and records management. A Communications Policy (approved in 2020) was developed to provide a framework for effective coordination of communication activities and dissemination of information. These efforts are aimed at enhancing understanding of the Bank's mandate and role in the economy by the public.

Through the Monetary Policy Statement, published at the beginning of the year, the Bank informs stakeholders about the framework for the formulation and implementation of monetary policy, where inflation trends and policy performance are reviewed and the policy choices for the ensuing year are articulated. The Monetary Policy Report (MPR) was introduced in August 2018 and presents the Bank's review of economic and inflation trends as well as policy performance. The report also provides an assessment of external and domestic economic and financial developments 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 to anchor public expectations of a low, predictable, and sustainable level of inflation. Furthermore, the Bank publishes the MPC meeting dates for the year ahead and the Governor delivers a statement at a press briefing subsequent to each meeting of the MPC to allow for engagement with the media and dissemination of the Bank's policy stance. Following each MPC meeting, a Press Release is issued, informing the public of the Committee's decision regarding the Bank Rate and the reasons for the policy choice.

However, it is worth noting that as new communication technologies increasingly disintermediate traditional media by allowing for new ways of interaction, comprehension of the whole communication process - from the central Bank at the sending end, the intermediation and interpretation of central bank messages through markets, media, and analysts, to the perception thereof by the recipients - becomes a crucial input into policy decisions. Thus, the Bank's communication is expected to adapt to these developments in pursuit of openness and transparency, and to enhance the effectiveness of policy transmission.

5. AUGUST 2021 MONETARY POLICY COMMITTEE DECISION

At the meeting held on August 19, 2021, the Monetary Policy Committee (MPC) of the Bank of Botswana decided to maintain the Bank Rate at 3.75 percent. Inflation rose from 8.2 percent in June to 8.9 percent in July 2021, remaining above the upper bound of the Bank's medium-term objective range of 3 - 6 percent. The latest increase in inflation mainly reflects the upward adjustment in domestic fuel prices in July 2021. However, inflation is projected to revert to within the objective range in the second quarter of 2022, mainly on account of the dissipating impact of the recent upward adjustment in value added tax (VAT) and administered prices from the inflation calculation; which altogether contributed 5.2 percentage points to the current level of inflation.

Overall, risks to the inflation outlook are assessed to be skewed to the upside. These risks include the potential for increase in international commodity prices beyond current forecasts; persistence of supply and logistics constraints due to possible maintenance of travel restrictions and lockdowns; and domestically-based risk factors relating to second-round effects of the recent increases in administered prices and inflation expectations that could lead to generalised higher prices. Furthermore, aggressive action by governments (for example, the Economic Recovery and Transformation Plan (ERTP)) and major central banks to bolster aggregate demand, as well as the successful rollout of the COVID-19 vaccination programmes, could add pressure to inflation.

These risks are, however, moderated by the possibility of weak domestic and global economic activity, with a likely further dampening effect on productivity due to periodic lockdowns and other forms of restrictions in response to the emergence of new COVID-19 variants. A slow rollout of vaccines resulting in the continuance of weak economic activity and the possible decline in international commodity prices could also result in lower inflation, as would capacity constraints in implementing the ERTP initiatives.

Real Gross Domestic Product (GDP) contracted by 8.6 percent in the twelve months to March 2021, compared to a growth of 2.2 percent in the corresponding period in 2020. The decline in output is attributable to the contraction in production of both the mining and non-mining sectors, mainly resulting from the impact of the strict COVID-19 pandemic containment measures. Mining output declined substantially by 27.8 percent in the year to March 2021 compared to a decline of 6.7 percent in 2020, as the sector, including its support service activities, underperformed. Similarly, non-mining GDP contracted by 3.1 percent in the twelve-month period ending March 2021, compared to a growth rate of 5 percent in the corresponding period in 2020. The decline in non-mining GDP was mainly due to lower output for the accommodation and food services, manufacturing, construction, and diamond traders, among others.

Projections by the Ministry of Finance and Economic Development and the International Monetary Fund (IMF) suggest a rebound in economic growth for Botswana in 2021. The Ministry projects a growth of 8.8 percent in 2021, before moderating to a growth of 5.5 percent in 2022. On the other hand, the IMF forecasts the domestic economy to grow by 8.3 percent in 2021; this is expected to moderate to 6.4 percent in 2022. The growth outcome will partly depend on the successful vaccine rollout.

Global output growth is forecast at 6 percent in 2021, reflecting expectations of strengthening economic activity in the latter part of the year, largely supported by additional fiscal support and the rollout of effective COVID-19 vaccines. However, global output growth is anticipated to moderate to 4.9 percent in 2022, as some economies return to their pre-COVID levels. Meanwhile, the South African Reserve Bank projects the South African GDP to grow by 4.2 percent in 2021, before slowing to 2.3 percent in 2022.

The MPC notes that the short-term adverse developments in the domestic economy occur against a growth-enhancing environment. This includes accommodative monetary conditions, improvements in water and electricity supply, reforms to further improve the business environment and government interventions against COVID-19, including positive news around the vaccination rollout programme. In addition, the successful implementation of ERTP should anchor the growth of exports and preservation of a sufficient buffer of foreign exchange reserves which have recently fallen to an estimate of P50.8 billion (9.4 months of import cover) in August 2021.

Overall, it is projected that the economy will operate below full capacity in the short to medium term and, therefore, not creating any inflationary pressures, going forward. The projected increase in inflation in the short term is primarily due to transitory supply-side factors that, except for second-round effects and entrenched expectations (for example, through price adjustments by businesses, contractors, property owners and wage negotiations), would not normally attract monetary policy response.

In this context, the MPC decided to continue with the accommodative monetary policy stance and maintain the Bank Rate at 3.75 percent. The Bank stands ready to respond appropriately as conditions dictate.

The remaining MPC meetings for 2021 are scheduled as follows:

October 21, 2021

December 2, 2021