MONETARY POLICY REPORT

DECEMBER 2020

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 approval by His Excellency, the President. In addition, the Bank uses the Bank Rate to influence short-term interest rates to steer the economy through business cycles, thus contributing to sustainable economic development.

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

The monetary policy stance is signalled by the Bank Rate. To support this signal, the Bank uses open market operations, which entail, primarily, auctioning of Bank of Botswana Certificates (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 MPC. The Committee comprises: the Governor (Chairman); Deputy Governors; the 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 per year, at which the monetary policy stance is determined. However, the Committee can meet more often if need be. Prior to the commencement of the year, the dates for the MPC meetings for the ensuing year are published.

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.

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 2020, monetary policy is being implemented in the context of projections for low inflation in the medium term, associated with subdued domestic demand resulting from the adverse effects of the lockdowns occasioned by the outbreak and subsequent spread of COVID-19,[1] restrained increase in personal incomes and expected 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 economic activity. Thus, the Bank Rate was maintained at 3.75 percent at the December 2020 MPC meeting.

Overall, risks to the inflation outlook are assessed to be balanced. Upside risks relate to the potential increase in international commodity prices beyond current forecasts, aggressive action by governments and major central banks to bolster demand, as well as the anticipated supply constraints due to travel restrictions and lockdowns, though abating. Domestically, acccelerated implementation of the Economic Recovery and Transformation Plan (ERTP) could lead to higher inflation. These risks are moderated by weak domestic and global economic activity, which could be exacerbated by periodic lockdowns due to prolonged COVID-19 infections, and the possible decline in international commodity prices. Furthermore, should there be implementation capacity constraints, this could hinder the effectiveness of the policy stimulus and ERTP initiatives, thus resulting in lower inflation.

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

Headline inflation averaged 1.2 percent in the third quarter of 2020, a decline from an average of 2.9 percent in the third quarter of 2019, mainly accounted for by a reduction in fuel prices. Inflation is forecast to remain below the lower bound of the Bank's 3 - 6 percent medium term objective range in the short term, mainly due to the significant downward adjustment in domestic fuel prices in the second quarter of 2020 and the disinflationary pressures anticipated from the adverse impact of the COVID-19 pandemic. However, inflation is expected to revert to within the objective range in the second quarter of 2021, influenced by the anticipated increase in domestic demand in response to the overall accommodative monetary conditions and implementation of the ERTP by Government; the envisaged increase in value added tax (VAT) and electricity tariffs; the likely increase in international commodity prices; as well as base effects associated with the decrease in fuel prices in 2020.

Gross Domestic Product (GDP) contracted by 4.2 percent in the twelve months to June 2020, compared to the 3.9 percent growth in the year to June 2019, mainly attributable to a reduction in output of both the mining and non-mining sectors, resulting from the adverse impact of the COVID-19 pandemic containment measures imposed to contain the spread of the coronavirus. Output growth for 2020 is projected to contract by 8.9 percent (Ministry of Finance and Economic Development (MFED) projections) mainly due to the negative impact of the COVID-19 pandemic. However, the prevailing accommodative monetary conditions, reforms to further improve the business environment and government interventions against COVID-19, including the implementation of the ERTP, should generally be positive for economic activity in the medium term.

[1] The lockdowns have resulted in restricted mobility which has halted both domestic and external economic activity and thus subdued domestic demand.

Annual growth in commercial bank credit[2] decreased to 4.9 percent in October 2020, from 6.2 percent in the corresponding period in 2019, reflecting, in part, the somewhat subdued demand for credit, as well as restrained supply of credit by banks on account of the uncertainty created by the COVID-19 pandemic.

At the end of September 2020, foreign exchange reserves amounted to P58.8 billion, a decrease of 18.3 percent from P72 billion in September 2019. The decrease was a manifestation of the balance of payments (BoP) deficit, given the subdued exports compared to higher growth rates for imports and government spending obligations. The current account of the BoP recorded a deficit of P7 billion in the second quarter of 2020, compared to a revised deficit of P219 million during the corresponding period in 2019.

The nominal effective exchange rate (NEER) of the Pula depreciated by 2.1 percent in the twelve months to November 2020, consistent with the transition from an annual upward rate of crawl of 0.3 percent implemented in 2019 to annual downward rates of crawl of 1.51 percent and 2.87 percent implemented effective January and May 2020, respectively. The Pula appreciated by 2 percent against the South African rand, but depreciated by 5.4 percent against the SDR in the twelve months to November 2020. In the year to October 2020, the real effective exchange rate (REER) depreciated by 1.4 percent due to the larger downward rate of crawl than the positive inflation differential between Botswana and trading partner countries.

Global economic output growth for the second quarter of 2020 was better than anticipated and a stronger performance is expected for the third quarter, as most countries rebound from the COVID-19 pandemic. The United States of America (US) GDP expanded by 33.1 percent in the third quarter of 2020, the largest expansion in history, mainly due to significant growth in personal spending. Similarly, growth in the euro area increased to 12.7 percent in the third quarter of 2020, a recovery from a contraction of 11.8 percent in the second quarter, as the lifting of lockdowns imposed to contain the spread of the pandemic boosted demand and economic activity. GDP growth in the UK was 15.5 percent in the third quarter of 2020 as restrictions on movement eased during the quarter, following a contraction of 19.8 percent in the previous quarter. Economic activity softened in the emerging market economies due to weaker external and domestic demand arising from the COVID-19 pandemic and tightener financial conditions. Meanwhile, in South Africa, output contracted by an annualised 51 percent in the second quarter of 2020, as the negative effects of the COVID-19 pandemic extended the recession into a fourth consecutive quarter.

The global economic outlook was revised upwards in the IMF's October 2020 World Economic Outlook (WEO), on account of better-than-anticipated second quarter GDP outturns, mostly in advanced economies, as well as indications of a stronger recovery in the third quarter. Beyond this, the recovery going into the fourth quarter of 2020 is projected to be slow due to the resurgence of COVID-19 infections across the globe. The October 2020 WEO forecasts the global economy to contract by 4.4 percent in 2020 (an improvement of 0.5 percentage points from the June 2020 forecast), before rebounding to a growth of 5.2 percent in 2021 as economic activity normalises, buoyed by policy support.

The global rough diamond price index increased in the third quarter of 2020 as COVID-19 restrictions continued to ease in most countries across the world thus, improving the manufacturers' demand for rough diamonds and diamond trade, generally. In the third quarter of 2020, international oil (Brent crude and OPEC) prices increased considerably, to average slightly above USD40 per barrel, influenced by expansion in demand associated with relaxation of lockdowns in many countries as well as tangible expectations of finding a COVID-19 vaccine. Meanwhile, the United Nations' Food and Agriculture Organisation (FAO) food price index increased in the third quarter of 2020, supported by the rise in vegetable oil prices. Moreover, the recovery in global demand following relaxation of some COVID-19 containment measures put some impetus on food prices.

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2 Commercial banks' data for October 2020 are preliminary.

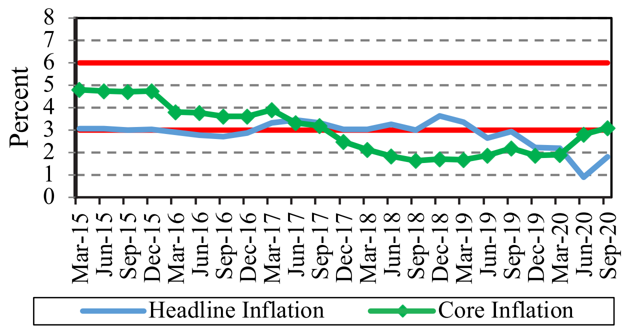
3. RECENT ECONOMIC DEVELOPMENTS

3.1 Inflation environment

Headline inflation decreased in the third quarter of 2020

Headline inflation averaged 1.2 percent in the third quarter of 2020 and was lower than the 2.9 percent average inflation in the third quarter of 2019 (Chart 3.1), mostly accounted for by lower fuel prices. Headline inflation increased from 1.8 percent in September to 2.2 percent in October 2020 (Table 3.1), and remained below the lower bound of the Bank's medium-term objective range of 3 – 6 percent. The increase in inflation between September and October 2020 mainly reflects the upward adjustment in domestic fuel prices and postal services tariffs, which are estimated to have increased inflation by approximately 0.29 and 0.03 percentage points, respectively.

Chart 3.1: Botswana Headline and Core Inflation



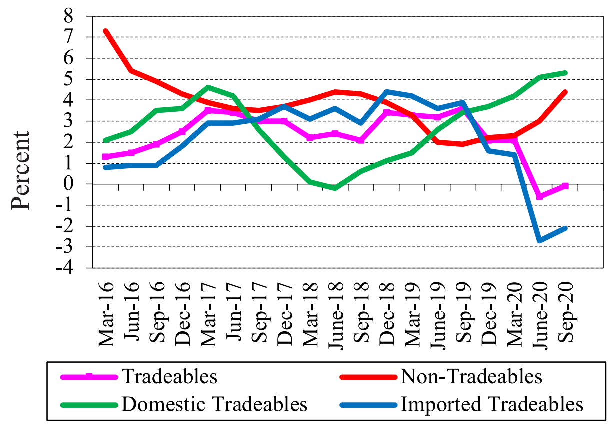
Source: Statistics Botswana and Bank of Botswana

Note: Core Inflation is headline inflation excluding administered prices.

Prices for domestic tradeables increased while those for imported tradeables decreased in the third quarter of 2020

Inflation for domestic tradeables increased to an average of 5.3 percent in the third quarter of 2020, from an average of 3.2 percent in the third qurter of 2019, reflecting the increase in food prices (Chart 3.2). Conversely, imported tradeables inflation decreased from an average of 3.8 percent to an average of -2.4 percent in the same period, reflecting the downward adjustment in domestic fuel prices. As a result, all tradeables inflation decreased from an average of 3.5 percent in the third quarter of 2019 to an average of -0.4 percent in the corresponding quarter of 2020, while inflation for non-tradeables increased from an average of 2 percent to an average of 3.4 percent in the same period. In October 2020, domestic tradeables, imported tradeables, non-tradeables and all tradeables inflation were 5.5 percent, -1.3 percent, 4.6 percent and 0.5 percent, respectively.

Chart 3.2: Inflation for Tradeables and Non-Tradeables



Source: Statistics Botswana

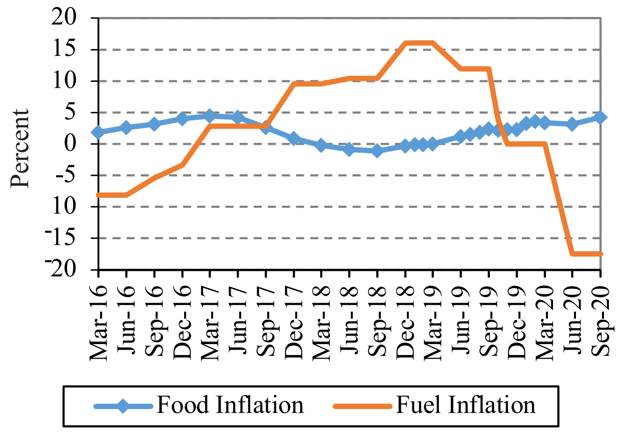
The upward trend in non-tradeables inflation from June 2019 and domestic tradeables inflation from June 2018 is mainly due to the increase in administered prices and the cost of food, respectively. The increase in food prices is a result of bad weather conditions experienced in the 2018/19 ploughing season, and also the effects of COVID-19 in 2020.

This, therefore shows that the upward trend in both instances is not as a result of demand pressures in the domestic economy, something which is consistent with a negative output gap discussed later in Section 4.2.

Inflation excluding administered prices and inflation excluding food and fuel increased, while trimmed mean inflation decreased in the third quarter of 2020

The trimmed mean inflation (CPITM) decreased to 1.2 percent in the third quarter of 2020, from 2.9 percent in the third quarter of 2019, while inflation excluding administered prices (CPIXA) averaged 2.9 percent compared to 2.2 percent in the same period due to the increase in prices for food and non-alocholic beverages (Table 3.1). Inflation excluding food and fuel (CPIXFF) averaged 2.9 percent in the third quarter of 2020, higher than the 2.1 percent in the corresponding quarter of 2019, attributable to the upward adjustment in public transport fares. In October 2020, CPITM, CPIXA and CPIXFF were 2.2 percent, 3.4 percent and 4.1 percent, respectively.

Chart 3.3: Food and Fuel Inflation



Source: Statistics Botswana and Bank of Botswana

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

Category of commodities	**Basket Weights**	**October 2020**	**Q3 2020**	**Q3 2019**
Food and non-alcoholic beverages	13.6	4.3	4.1	2.0
Alcoholic beverages and tobacco	4.3	6.6	6.5	3.6
Clothing and footwear	6.0	2.7	2.4	1.1
Housing, water, electricity, gas and other fuels	17.5	6.6	6.1	1.7
Furnishing, h/h equipment and routine maintenance	4.9	2.1	2.0	2.2
Health	3.4	1.5	1.5	1.0
Transport	23.4	-2.5	-5.9	6.1
Communications	6.9	0.9	0.5	0.0
Recreation and culture	2.8	0.2	-0.4	0.1
Education	4.6	4.7	4.7	3.2
Restaurants and hotels	3.7	3.0	3.0	2.3
Miscellaneous goods and services	9.0	0.9	0.6	5.0
Annual Inflation (All items)	**100.0**	**2.2**	**1.2**	**2.9**
CPITM		2.2	1.3	2.7
CPIXA		3.4	2.9	2.2
CPIXFF		4.1	2.9	2.1

Source: Statistics Botswana and Bank of Botswana calculations

Box 1: Administered Prices

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. However, monetary policy does not have any direct influence on these price changes and would therefore, not trigger a direct policy response. Policy may, nevertheless, respond to the resultant second round effects as free market prices also react.

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. 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 3.2: Administered Items

Item code	Administered prices	Weights
147	Monthly rent BHC House Type LC48	0.294
148	Monthly rent BHC Type 2 "Improved"	0.379
161	Water: 10kls per month	1.168
162	Water: 20kls per month	0.779
164	Electricity: 100kwh per month	2.143
165	Electricity: 500kwh per month	1.428
167	Paraffin per litre	0.064
237	Consultation with Government doctor	0.168
247	Rate to stay in a public hospital for 24 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 comp. 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**

Source: Statistics Botswana

3.2 Recent domestic economic developments

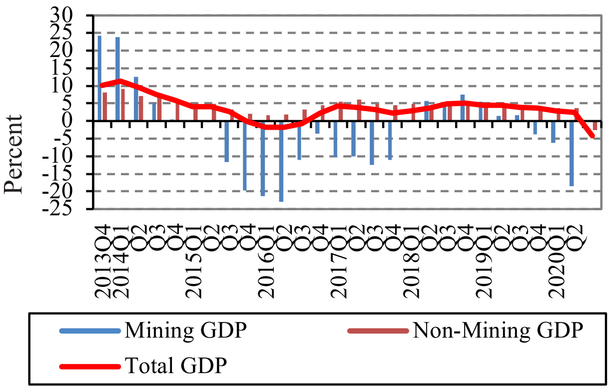
GDP contracts in the second quarter of 2020

Real GDP contracted by 4.2 percent in the twelve months to June 2020, compared to the 3.9 percent growth in the year to June 2019 (Chart 3.4 and Table 3.3). This decline in output is attributable to the contraction in output of both the mining and non-mining sectors, resulting from the negative impact of the COVID-19 pandemic containment measures on economic activity. Mining output contracted by 18.6 percent compared to the 1.5 percent growth in the corresponding period ending June 2019, mainly due to weaker performance of the diamond, copper, soda ash and other mining subsectors. In the twelve months period to June 2020, overall global demand and sales for rough diamonds were adversely affected by COVID-19 international travel restrictions. Copper output contracted by 100 percent following cessation of production at the Mowana Mine in November 2018. Coal output also contracted by 21.4 percent due to lower demand at Morupule B power station, which was operating below capacity, with one of the units placed under care and maintenance in the third quarter of 2019.

Non-mining GDP contracted by 2.6 percent in the year to June 2020 compared to the 4.2 percent growth in the corresponding period in 2019. The decline in non-mining GDP was mainly due to contractions in output of the trade, hotels and restaurants[3] (-7.9 percent), construction (-6.8 percent), manufacturing (-5.8 percent) and transport and communications (-1.1 percent) sectors. In addition, the deceleration in growth of the finance and business services, general government, agriculture and social and personal services sectors contributed to the overall output decline of the non-mining sector. Further, the GDP contraction in the 12 months to June 2020 is in line with similar lacklustre performance in high frequency indicators, such as stock market indices and importation of cement. The domestic company index, the foreign company index and importation of cement contracted by 5.6 percent, 0.7 percent and 0.5 percent, respectively, in the twelve months to June 2020. Meanwhile, water and electricity output expanded by 9 percent in the year to June 2020 from a lower expansion of 4.3 percent in the corresponding period ending in June 2019.

Meanwhile, Statistics Botswana reported that real GDP contracted by 24 percent in the second quarter of 2020, from the 3 percent growth in the second quarter of 2019[4].

Chart 3.4: 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 to 4.6 percent in the twelve-month period to June 2020, compared to 3.4 percent in the corresponding period to June 2019 (Table 3.3). This was attributable to the acceleration in growth of central government consumption, from 3.5 percent to 4.9 percent. Meanwhile, household final consumption grew by 2.4 percent compared to 2.5 percent registered in the previous period. The lower growth in household final consumption was mainly due to a contraction in non-marketed household final consumption[5] and non-profit institutions.

Gross fixed capital formation (GFCF) contracted by 3 percent in the year to June 2020, compared to the 6.5 percent growth in the corresponding period

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3 This sector also includes tourism.

4 Statistics Botswana calculates annual GDP growth for a given quarter on the basis of quarterly output in that period compared to the output for the corresponding quarter in the previous year.

5 Marketed household consumption refers to goods and services purchased for consumption by households.

the previous year. The decline in GFCF was due to the reduction in investment in transport and equipment (from 16.7 percent to -5 percent), investment in construction (from 3.8 percent to -6.5 percent), as well as investment in mineral prospecting (from 2.5 percent to -2 percent). Meanwhile, investment in machinery and equipment fell by 3.8 percent in the second quarter of 2020 compared to 10.1 percent growth in the corresponding period last year and this was reflected in the slower growth in imports of machinery and electrical equipment due to the COVID-19 containment measures in effect since March 2020 that led to international supply disruptions.

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

	2019 Q2	2020 Q1	2020 Q2
Total GDP	**3.9**	**2.6**	**-4.2**
By Sector			
Mining	1.5	-6.1	-18.6
Non-Mining	4.2	3.6	-2.6
Agriculture	1.7	*-0.7* (-0.9)	0.2
Manufacturing	3.1	2.9	-5.8
Water and Electricity	4.3	8.5	9.0
Construction	3.2	3.1	-6.8
Trade, Hotels and Restaurants	4.4	3.8	-7.9
Transport and Communications	6.0	4.5	-1.1
Finance and Business Services	5.3	6.1	1.6
General Government	3.9	3.9	3.3
Social and Personal Services	1.7	*-0.7* (2.7)	0.2
By Expenditure			
Government Final Consumption	3.4	*4.7* (4.1)	4.6
Household Final Consumption	2.5	*5.7* (3.9)	2.4
Gross Fixed Capital Formation	6.5	*7.7* (6.7)	-3.0
Exports	3.0	-20.5	-38.5
Imports	11.8	*5.1* (5.8)	-1.9

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

Diamond production decreased in the third quarter of 2020

Debswana produced 4.8 million carats of diamonds in the third quarter of 2020, 15.3 percent lower than the 5.7 million carats produced in the corresponding period in 2019, due to lower production at Jwaneng and Orapa mines[6]. Production at Jwaneng and Orapa mines decreased by 32 percent and 1 percent, respectively, in the review period. The overall significant decline in production was mainly driven by planned reductions in production to reflect the lower demand for rough diamonds due to COVID-19 pandemic and the related measures to safeguard the workforce. The COVID-19 containment measures and the resultant limited midstream diamond cutting and polishing capacity, particularly in India, adversely affected the demand for rough diamonds. Debswana's production target for 2020 has been revised downward to 17.4 million carats from the initial 25 million carats, reflecting the impact of COVID-19 on mining operations. The revision is consistent with that of De Beers, which has adjusted production guidance for 2020 to 25 - 27 million carats (previously 32 - 34 million carats).

Production by Lucara Diamond Corporation (Karowe Mine) decreased by 15.3 percent to 88 908 carats in the third quarter of 2020, from 104 990 carats in the corresponding period in 2019[7]. The mine continued operations throughout the COVID-19 pandemic period, hence the decrease in production is mainly attributable to lower recovery of smaller-sized diamonds and the absence of re-processing of tailings in the period under review. A total of 193 special stones (single diamonds larger than 10.8 carats) were recovered in the third quarter of 2020, including 8 diamonds greater than 100 carats and 3 diamonds greater than 200 carats. Special stones accounted for 6.5 percent of total carats recovered during the period. With respect to quarterly performance, production for the third quarter of 2020 decreased by 12.1 percent from 101 203 carats in the second quarter of 2020. In July 2020, Lucara announced a ground-

6 Orapa output constitutes production from the cluster of Orapa, Damtshaa and Letlhakane mines.

7 Lucara's production for the third quarter of 2020 accounts for a very small proportion of total global production and a significant part of the value of the Company's production is mainly attributable to large and higher-quality diamonds from Karowe Mine.

breaking partnership agreement to supply the HB Group, headquartered in Antwerp, Belgium, with diamonds larger than 10.8 carats from the Karowe Mine for the rest of 2020. At the beginning of the third quarter of 2020, the company earned revenue amounting to USD 25.9 million after sales from this partnership agreement.

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

Government budget was in deficit of P7.4 billion in the second quarter of the 2020/21 fiscal year (Table 3.4). The deficit was largely attributable to the less-than-anticipated revenue and grants, resulting from lower domestic taxes and mineral revenue than was projected. Total revenues and grants were P10.3 billion in the second quarter of the 2020/21 fiscal year, compared to P13.1 billion anticipated in the revised budget for the year, assuming equal quarterly distribution. Total government expenditure and net lending was P17.6 billion, higher than the P16.5 billion originally anticipated.

Government expenditure has been revised downwards to P66 billion for the 2020/21 fiscal year, which is P1.7 billion lower than the original budget. The budget deficit has also been revised upwards significantly to P13.6 billion from the original P5.2 billion, reflecting the downward revision of revenue and grants from P62.4 billion to P52.3 billion.

Table 3.4: Quarterly Budget Outturns (P Million)

	Total Revenues and Grants	Total Expenditure and Net Lending	Budget Surplus/ Deficit
2019/20 Q2	13 533	17 974	-4 441
2019/20 Q3	11 960	15 953	-3 992
2019/20 Q4	11 713	16 614	-4 901
2020/21 Q1	12 788	14 303	-1 515
2020/21 Q2	10 273	17 636	-7 362

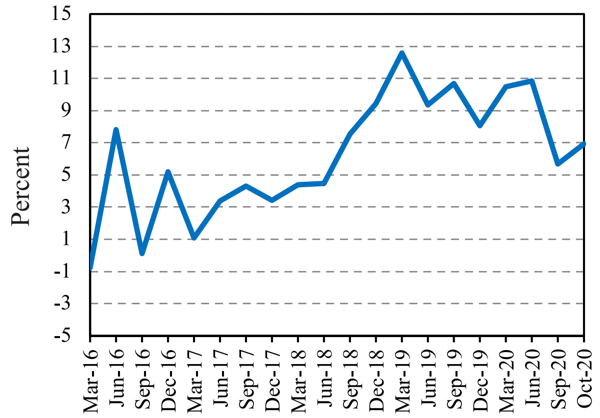
Source: Cash Flow Unit, Ministry of Finance and Economic Development

3.3 Monetary developments

Growth in banking sector assets accelerates in October 2020

Annual growth in banking sector assets increased from 5.9 percent in October 2019 to 6.9 percent in October 2020 (Chart 3.5). This was due to the increase in holdings of Bank of Botswana Certificates and debt securities as well as balances due to foreign banks. The overall slight increase in the growth of loans and advances, which accounted for the largest proportion of commercial banks' assets (62.5 percent) also contributed to the acceleration.

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



Source: Commercial Banks

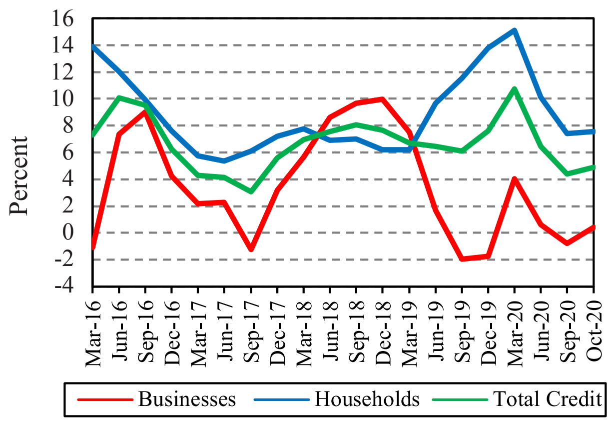
Credit growth decelerated in the year to October 2020

Growth in commercial bank credit urged up slightly to 4.9 percent in the twelve-months to October 2020, having been on a downward trajectory since April 2020. However, compared to the year ending in October 2019, the annual credit growth was lower by 1.3 percentage points in October 2020 (Chart 3.6). The lower growth in commercial bank credit is, in part, indicative of the somewhat restrained demand for credit, as well as restrictive supply of credit by banks on account of the uncertainty related to COVID-19 pandemic.

Growth in household loans decreased to 7.5 percent in the twelve months to October 2020, from 12.1 percent in the corresponding period in 2019. In particular, there was a significant decline in growth of credit card advances. Furthermore, there was a deceleration in growth of mortgages, personal unsecured lending which is mostly accessed through scheme loan arrangements and motor vehicle loans in October 2020. Despite the deceleration in household credit growth, the share of the sector in total lending by commercial banks increased to 64.6 percent in October 2020, from 63 percent in October 2019.

Lending to the business sector increased by 0.4 percent in the twelve months to October 2020, compared to a contraction of 2.6 percent in the corresponding period in 2019. Meanwhile, credit to businesses excluding parastatals contracted by 0.1 percent, annually, in October 2020, an improvement from a contraction of 1.5 percent in September 2020 and the 5.4 percent annual contraction in October 2019. Repayments of some credit facilities, as well as decreased utilisation of overdraft facilities by some companies in mining, trade, real estate and agriculture contributed to the decline in credit to businesses excluding parastatals. Credit to parastatals increased by 6.3 percent in the year to October 2020, compared to the 53.3 percent expansion in the twelve months to October 2019.

Chart 3.6: Commercial Banks - Year-on-Year Growth in Total Credit

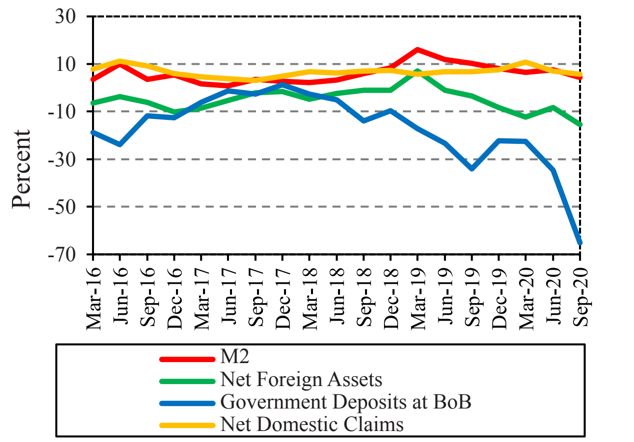


Source: Commercial Banks

Growth in money supply decreased in September 2020

Annual growth in money supply (M2)[8] was 4.3 percent in September 2020, lower than the 10.2 percent in the corresponding period in 2019 (Chart 3.7). The lower growth was as a result of base effects associated with the increase in net foreign assets on account of foreign exchange inflows from the Southern African Customs Union (SACU) receipts and dividends from Debswana in 2019.

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



Source: Other Depository Corporation and Bank of Botswana

The nominal BoBC stop-out yields decreased in the third quarter of 2020

The 3-month BoBC[9] stop-out yield decreased from an average of 1.73 percent in the third quarter of 2019 to 1.04 percent in the corresponding period in 2020. Meanwhile, the real interest rate for the 3-month BoBC increased from -1.17 percent in the third quarter of 2019 to -0.19 percent in the corresponding period in 2020, reflecting the larger decrease in inflation rate compared to the decline in nominal interest rate in the same period. The 7-day BoBC stop-out yield decreased from an average of 1.53 percent in the third quarter of 2019 to 1.02 percent in the corresponding period in 2020, while the real rate increased from -1.43 percent to -0.72 percent in the same period.

The stop-out yield for the 7-day BoBC was constant at 1.03 percent in September, October and November 2020. The real rate of interest for the 7-day BoBC decreased from -0.76 percent in September to -1.14 percent in October 2020, reflecting the significant increase in the inflation rate. Box 2 discusses reforms to monetary operations.

[8] The growth in money supply was due to the decrease in net foreign assets and the increase in credit to the private and parastatal sectors, as well as the decline in government deposits at Bank of Botswana to fund government operation.

[9] 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.

Moody's and S&P Global Ratings downgrade Botswana's outlook from stable to negative

Following an out-of-calendar review[10] in May 2020, Moody's Investors Service affirmed Botswana's rating of 'A2' for long-term bonds denominated in both domestic and foreign currency, but revised the outlook from stable to negative. This follows an earlier affirmation of both the credit rating and stable outlook in March 2020. The revision of the outlook reflects the increasing risks of lower growth, structural budget deficits, likely resultant increase in government borrowing and, consequent weakening of fiscal and external buffers. The outlook could be changed to stable if the observed deterioration of the fiscal performance/outturn caused by the COVID-19 pandemic stabilises. The affirmation of the rating at 'A2' was underpinned by strong, albeit deteriorating fiscal and external buffers, in particular, relatively low public debt level, high debt affordability, as well as fiscal and external liquidity buffers that help in mitigating the impact of COVID-19 pandemic.

In September 2020, 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. However, the economic outlook was changed from stable to negative. The negative outlook was premised on expectations of stronger downward pressure on Botswana's economic, external and fiscal performance over the next two years as a result of the adverse impact of the COVID-19 pandemic, exacerbated by weaker diamond exports. S&P indicated that the affirmation of the ratings was underpinned by stable and predictable institutional frameworks, positive impact of the monetary policy framework, adherence to rule of law and effective policymaking, all of which contribute to macroeconomic stability.

[10] The review was prompted by the risks associated with COVID-19 shocks, given Botswana's strong dependency on the diamond industry for growth, exports and budget revenues.

Box 2: Reforms to Monetary Operations Framework

The Bank continues to monitor developments in money market liquidity conditions. In addition, the Bank evaluates monetary policy implementation framework on a regular basis for effectiveness and introduces refinements where necessary. In that regard, the Bank discontinued the issuance of the 91-day BoBCs effective October 30, 2020 and reintroduced the 3-month Treasury Bill (T-Bill). This followed the decision by Government, as authorised by Parliament, to increase the ceiling of the bond issuance programme from P15 billion to P30 billion. The discontinuation of the issuance of the 91-day BoBCs is intended to avoid competition with the 3-month T-Bill and, therefore, supports the building up of the Government T-Bill market. In addition, the discontinuation of the 91-day BoBC allows for a clear separation between monetary policy operations and debt management and this is in line with best international practice.

In another development, since the introduction of the Primary Reserve Requirement Averaging (PRRA) in 2019, most commercial banks continue to actively use it as a tool for effective management of liquidity. It is envisaged that this will over time lead to reduced demand for excess reserves held by commercial banks for precautionary purposes, thus freeing up additional resources for productive lending. Additional 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.

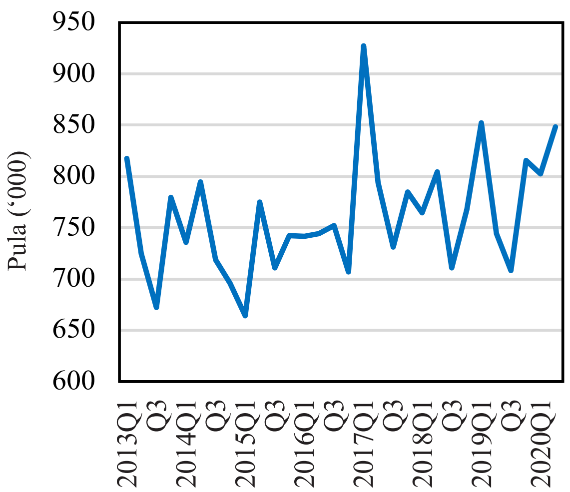
3.4 Asset markets

Property market generally improves in the second quarter of 2020

According to the latest (2020Q2) Riberry Report[11], the residential rental market performed better in the second quarter of 2020, compared to the first quarter of 2020, due to good demand for sales and rentals for low-end properties, despite the COVID-19 lockdown in the second quarter of 2020. However, demand and supply for rentals and sales in the medium end property segment decreased marginally in the period under review.

The average price for residential properties sold in the second quarter of 2020 increased by 5.7 percent to P847 989 compared to the previous quarter (Chart 3.8), indicative of the high value of properties traded in the quarter under review. Looking ahead, the demand for lower-end, medium and prime located residential housing is expected to improve given the relative affordability of properties in these categories compared to those in the upper-end market.

Chart 3.8: Ribbery 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). Despite the COVID-19 movement restrictions and the general weak demand for office space, there was still some take-up of office space, although limited, at the CBD by Government, a major consumer, as well as by some corporates. Going forward, 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.[12] Meanwhile, 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 of retail space is expected to rise due to the development of a major shopping centre in the CBD, while another one is proposed for Mogoditshane. In addition, other centres with good demand for retail space are Jwaneng, Maun, Francistown, Mahalapye and Palapye. 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 bigger warehouse space has decreased, while the demand has improved.[13] 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.

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

12 Prime rentals are about P100/m^2. 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/m^2, while prime industrial areas like Gaborone International Commerce Park cost P65/m^2.

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

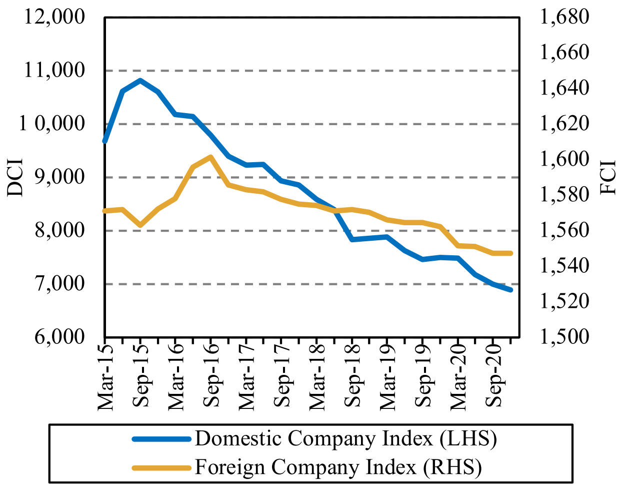
Stock market index declines

The Domestic Companies Index (DCI) declined by 8.5 percent in the twelve months to October 2020 compared to a reduction of 5.3 percent in the year to October 2019 (Chart 3.9). The decline was mainly due to the lower share prices for FNBB, Letshego, Stanchart and Seedco, which fell by 23.2 percent, 17.5 percent, 15 percent and 16.7 percent, respectively, in the same period.

According to Stockbrokers Botswana, the continuous 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.

The Foreign Companies Index (FCI) declined by 1.1 percent in the year to October 2020, compared to a decline of 0.5 percent in the corresponding period ending in October 2019 (Chart 3.9). This was largely attributed to the year-on-year decrease in share price for Lucara (-61.5 percent), Tlou (-60 percent), and Minergy (-27.5 percent), on account of low trading activity and liquidity.

Chart 3.9: Stock Market Indices



Source: Botswana Stock Exchange

3.5 Balance of payments (BoP)

Current account records a deficit in the second quarter of 2020

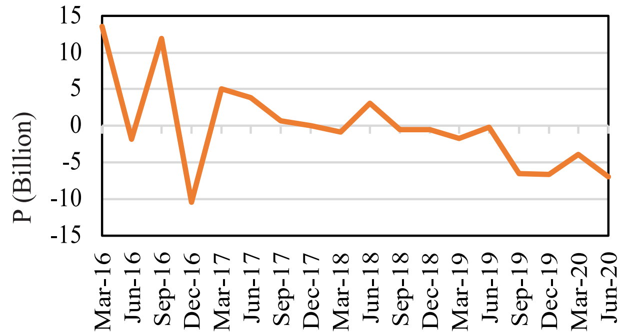
The current account is estimated to have recorded a deficit of P7 billion in the second quarter of 2020, compared to a revised deficit of P219 million during the corresponding period in 2019 (Chart 3.10). The merchandise trade, services and income accounts recorded a combined deficit of P10.6 billion, which was partly offset by a surplus of P3.6 billion in the current transfers account, which is dominated by the SACU revenue receipts. Exports decreased by 75 percent, while imports decreased by 23.1 percent, leading to a deficit of P8.7 billion in the merchandise trade account.

Diamond exports, which accounted for 81.3 percent of total exports of goods in the second quarter of 2020, fell from P16.1 billion in the second quarter of 2019 to P3.6 billion in the second quarter of 2020. During the same period, diamond imports also decreased from P5.5 billion to P4.4 billion. The decrease in diamond trade mainly stemmed from lower demand by rough diamonds importing countries, such as China due to the shutdown of retail stores following COVID-19 related lockdown and movement restrictions.

The other commodities that contributed to a decrease in exports include meat and meat products (77 percent), iron and steel products (67 percent), vehicles and transport equipment (66 percent) and machinery and electrical equipment (55 percent). In addition to diamond imports, other commodities that contributed to a decrease in imports are metal and metal products, and salt ores and related products that fell by 63 percent and 45 percent, respectively.

The negative balance in the income account resulted from the payments of investment income to foreign investors, mainly by the mining sector, which paid about P1.5 billion.

Chart 3.10: Quarterly Current Account Balance



Source: Bank of Botswana

The financial account records a surplus in the second quarter of 2020[14]

The financial account registered an estimated surplus of P6 billion during the second quarter of 2020, compared to a revised surplus of P488 million in the second quarter of 2019. The surplus was mainly attributable to an increase in offshore investments, particularly, by pension fund managers. This was complemented by a marginal decline in liabilities during the same period.

The balance of payments in deficit in September 2020

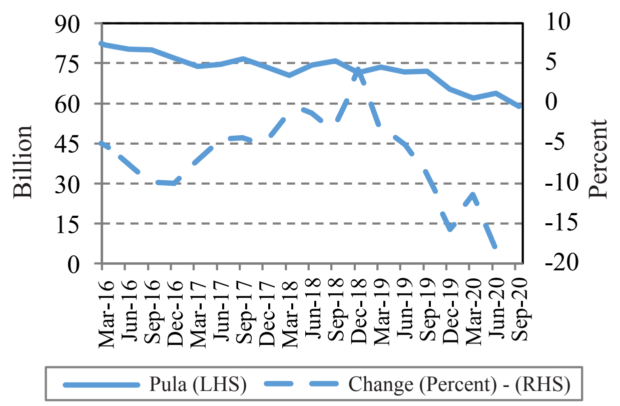
The overall BoP was in deficit of P21.1 billion for the twelve months to September 2020, compared to a deficit of P7.3 billion in the twelve months to September 2019. The deficit mainly resulted from larger payments for imports than receipts from exports in the current account, as alluded to earlier. This resulted in a higher deficit in the curret account, compared to a small surplus registered in the financial account.

Foreign exchange reserves decrease

As at the end of September 2020, foreign exchange reserves amounted to P58.8 billion, a decrease of 18.3 percent from P72 billion in September 2019 (Chart 3.11). The decrease was a result of the drawdown in foreign exchange reserves to finance government obligations, such as imports, external loan servicing and funding of embassies.

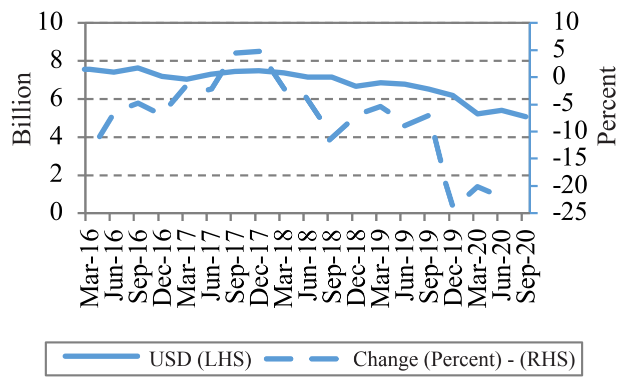
In foreign currency terms, the level of reserves decreased by 21.5 percent from USD6.5 billion in September 2019 to USD5.1 billion in September 2020 (Chart 3.12). The reserves also decreased by 25 percent from SDR4.8 billion to SDR3.6 billion over the same period. The level of reserves as at the end of September 2020 was equivalent to 10.9 months of import cover of goods and services.

Chart 3.11: Foreign Exchange Reserves in Pula and Annual Percentage Change



Source: Bank of Botswana

Chart 3.12: Foreign Exchange Reserves in US Dollars and Annual Percentage Change



Source: Bank of Botswana

[14] Compilation of balance of payments (BoP) is now aligned to the new Balance of Payments Manual (BPM 6), which amongst others, has made changes in signs asigned to assets and liabilities in the financial account from what prevailed in BPM5. According to BPM 5, increases in financial assets were recorded with negative signs, while decreases were recorded with positive signs. For the liabilities, increases were recorded with positive signs and decreases with negative signs. However, in BPM 6, increases in both assets and liabilities are recorded with positive signs, while decreases are recorded with negative signs. Therefore, previously, the analysis of financial account balances was based on net outflows/ inflows rather than in surpluses/deficits as it is the case under BPM6.

3.6 Exchange rate developments

For 2020, the Bank's implementation of the exchange rate policy (Box 3) entails the Pula basket weights of 45 percent for the South African rand and 55 percent for the SDR, which were maintained from 2019 and downward annual rates of 1.51 percent and 2.87 percent implemented effective January and May 2020, respectively. The revision in the annual downward rate of crawl effective May 2020 was in response to the adverse impact of COVID-19 containment measures on economic activity, hence the need for a relatively larger downward rate of crawl to further ease monetary conditions to help promote domestic economic activity and complement the reduction in the Bank Rate.

Bilaterally, the Pula appreciated by 2 percent against the South African rand, but depreciated by 5.4 percent against the SDR in the twelve months to November 2020 (Chart 3.13). In relation to the SDR constituent currencies, the Pula depreciated by 9.4 percent against the euro, 7.9 percent against the Chinese renminbi, 6.5 percent against the Japanese yen, 4.6 percent against the British pound and 1.5 percent against the US dollar.

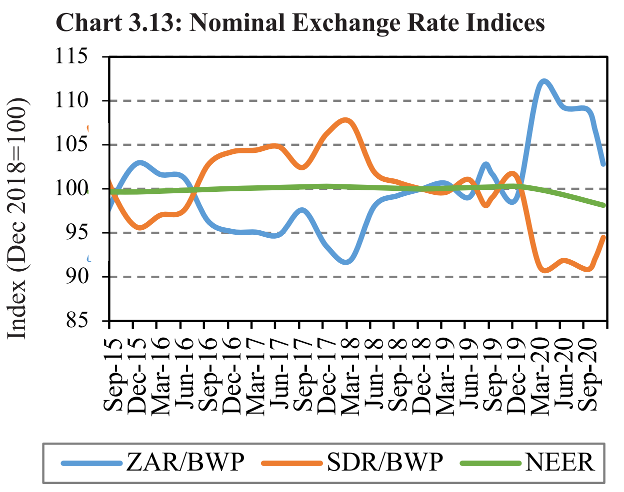
The movement of the Pula against the SDR constituent currencies largely reflects the performance of the South African rand against the SDR currencies. Notably, in the same review period, the South African rand depreciated by 7.3 percent against the SDR. With respect to the SDR constituent currencies, the South African rand depreciated by 11.2 percent against the euro, 9.7 percent against the Chinese renminbi, 8.4 percent against the Japanese yen, 6.5 percent against the British pound and 3.4 percent against the US dollar.

The depreciation of the South African rand against most of the major trading currencies was in response to both international and domestic factors. Internationally, the adverse economic impact of the global spread of COVID-19, as well as protracted US-China tension[15], continue to weigh down on investor sentiment for emerging markets currencies, especially the South African rand, as investors fled to safe-haven currencies, such as the US dollar.

Locally, the South African rand was further undermined by weak performance of the mining and manufacturing sectors, excerbated by recurring nationwide power cuts. Furthermore, Moody's and Fitch Ratings downgraded South Africa's sovereign credit ratings further into junk status, stating that COVID-19 aggravated South Africa's fiscal challenges and exacerbated the upward trend in the country's government debt burden, contributing to the depreciation of the rand. The recent Medium-term Budget Policy Statement (MTBPS) revealed that South Africa's fiscal position will remain under pressure on the back of elevated government debts and subdued growth.

However, the South African rand gained strength against all major currencies in the past four months on the back of improving business confidence in South Africa, as further lifting of COVID-19 containment measures boosted manufacturing output, exports and imports. Data released by the South African Chamber of Commerce and Industry revealed that the business confidence index increased from 82.8 in July to 85.7 in September 2020. The South African rand continued to recover in November 2020, due to rising investor risk appetite for high-yielding assets of emerging market economies owing to mounting market optimism regarding the successful trials of a COVID-19 vaccine and Joe Biden's victory in the US presidential elections. These two factors are expected to lead to a faster than anticipated recovery in global growth.

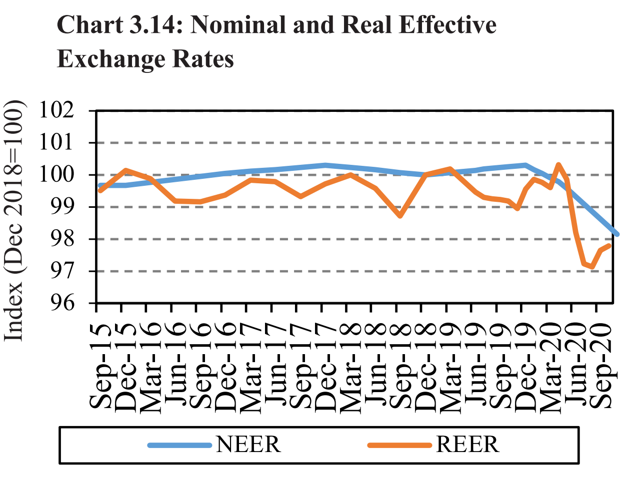
[15] The increasing risk aversion on account of escalating tensions between China and the US, a retaliation battle that may have implications on global trade and growth recovery.



Source: Bank of Botswana

NEER depreciated in November 2020

The NEER of the Pula depreciated by 2.1 percent in the twelve months to November 2020 (Chart 3.13), consistent with the transition from an annual upward rate of crawl of 0.3 percent implemented in 2019 to annual downward rates of crawl of 1.51 percent and 2.87 percent implemented effective January and May 2020, respectively.



Source: Bank of Botswana

REER depreciated in October 2020

The REER depreciated by 1.4 percent in the twelve months to October 2020 (Chart 3.14), due to the larger downward rate of crawl than the positive inflation differential between Botswana and trading partner countries. With respect to bilateral movements against the Pula basket currencies, the real Pula exchange rate (using headline inflation) appreciated by 3.3 percent against the South African rand but depreciated by 5 percent against the SDR. Against the SDR constituent currencies, the Pula depreciated by 7.6 percent against the Chinese renminbi, 6.5 percent against the euro, 5.9 percent against the Japanese yen, 3.5 percent against the US dollar and 2.9 percent against the British pound.

Box 3: Botswana's Exchange Rate Framework

The Exchange Rate Policy

Botswana's exchange rate policy is 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 problems 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.

3.7 Recent global economic developments

Global growth subdued

The October 2020 WEO was more optimistic on growth prospects than the June 2020 WEO Update, on account of better performance than anticipated for the second quarter of 2020, a stronger performance of the third quarter, as well as immense policy support. In most advanced economies, economic activity improved sooner than expected, following the easing of lockdowns. China avoided a recession with positive growth in both the second and third quarters of 2020, contributing to the optimism on global growth. Although global economic activity strengthened further in the third quarter of 2020, risks to recovery remain large, owing to possible resurgence in infections and uncertainty around wider availability and distribution of the COVID-19 vaccine. This could result in continuation of restricted economic activity and uncertainty. For 2019, global output growth is estimated at 2.8 percent, lower than the 3.5 percent estimate for 2018 (Table 3.5).

The US economy expanded

US output grew by 33.1 percent in the third quarter of 2020, compared to a contraction of 31.4 percent in the second quarter, as the economy rebounded from the COVID-19 pandemic. The realised expansion was the largest in the history of the US and was higher than the market expectation of an expansion of 31 percent, mainly attributable to growth in personal spending. Growth also reflected increases in private inventory investment, exports, non-residential fixed investment and residential fixed investment.

Euro area growth recovers

In the euro area, economic growth increased by 12.7 percent in the third quarter of 2020, a recovery from a contraction of 11.8 percent in the second quarter, and surpassing the market expectation of 9.4 percent. All the major economies in the economic bloc registered positive GDP growth as the lifting of lockdowns imposed to contain the spread of the pandemic boosted demand and economic activity. Output growth in France, Spain, Italy and Germany rose by 18.2 percent, 16.7 percent, 16.1 percent and 8.2 percent, respectively.

UK economy recovers

GDP in the UK grew quarter-on-quarter by 15.5 percent in the third quarter of 2020, following a contraction of 19.8 percent in the second quarter of 2020, reflecting the continued easing of lockdown restrictions as well as some recovery of activity from the steep contraction in April 2020. The increase in output for the construction (41.7 percent), manufacturing (18.7 percent), and services (14.2 percent) sectors contributed to the expansion.

Emerging markets' growth moderated

For emerging market economies, output growth softened in the second quarter, primarily due to weaker external and domestic demand arising from containment measures imposed to slow the spread of COVID-19. Moreover, tightening financial conditions, capital outflows, the greater importance of sectors severely affected, such as tourism and overwhelmed health care systems weighed on economic activity in emerging countries. In China, output grew by 4.9 percent in the third quarter of 2020, higher than the expansion of 3.2 percent in the second quarter, as industrial production, a gauge of manufacturing, mining and utilities, rose by 5.8 percent, while the services sector grew by 4.3 percent, signalling a more broad based growth in the economy. Moreover, rising global demand for medical equipment and work-from-home technology have boosted Chinese exports.

In India, GDP contracted year-on-year by 23.9 percent in the second quarter of 2020, significantly lower than the 3.1 percent expansion in the first quarter of 2020, and worse than the market forecast decline of 18.3 percent. The contraction was the largest since records began in 1996, following several lockdowns since mid-March 2020, thereby halting most economic activities. Contraction in the construction, hotels and transportation, as well as manufacturing sectors contributed to the overall decline of the economy.

South African economy in a recession

Regionally, output in South Africa contracted substantially by an annualised 51 percent in the second quarter of 2020, following a contraction of 1.8 percent in the first quarter of 2020. This marked the fourth consecutive quarterly contraction, mainly because of the faltering foreign demand

and disrupted global supply chains. The largest negative contributors to GDP growth in the second quarter were the construction, manufacturing, mining and trade and transport industries, which contracted by 76.6 percent, 74.9 percent, 73.1 percent and 67.6 percent, respectively. The agriculture, forestry and fishing industry, which grew by 15.1 percent, was the only positive contributor to GDP growth.

Table 3.5: Growth Estimates and Projections

	Estimate		Projection	
	2018	2019	2020	2021
Global	**3.5**	**2.8**	**-4.4**	**5.2**
Advanced economies	**2.2**	**1.7**	**-5.8**	**3.9**
USA	3.0	2.2	-4.3	3.1
Euro area	1.8	1.3	-8.3	5.2
UK	1.3	1.5	-9.8	5.9
Japan	0.3	0.7	-5.3	2.3
EMDEs	**4.5**	**3.7**	**-3.3**	**6.0**
China	6.7	6.1	1.9	8.2
Brazil	1.3	1.1	-5.8	2.8
India	6.1	4.2	-10.3	8.8
Russia	2.5	1.3	-4.1	2.8
South Africa	0.8	0.2	-8.0	3.0
Botswana	**4.5**	**3.0**	**-9.6 (-8.9)**	**8.7 (7.7)**

Source: IMF WEO October 2020 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 third quarter of 2020

The global rough diamond price index increased slightly by 0.47 percent from 126.6 points in the second quarter of 2020 to 127.2 points in the third quarter of 2020 as COVID-19 restrictions continued to ease in most countries across the world thus, improving trade of diamonds and manufacturers' demand and trade for rough diamonds. Meanwhile, owing to the restrictions on movement of people and supply disruptions across the globe, De Beers continued to implement a more flexible approach during the sixth and seventh sales cycles of 2020, with the normal week-long sight events extended towards near continuous sales. Rough diamond market showed some continued improvement throughout August and into September 2020, as manufacturers focused on meeting retail demand for polished diamonds. Meanwhile, the recovery and demand are still at an early stage and are expected to take some time to get back to pre-COVID-19 levels of demand. The global rough diamond price index averaged 131.5 in November 2020.

The global polished diamond price index decreased by 1.3 percent from 207.7 in the second quarter of 2020 to 205.1 in the third quarter of 2020. In November 2020, the global polished price index averaged 207 points, slightly higher than the 206.8 points in October, as the polished market showed signs of improvement due to gradual increase in demand from the US and China.

Oil prices increased significantly in the third quarter of 2020

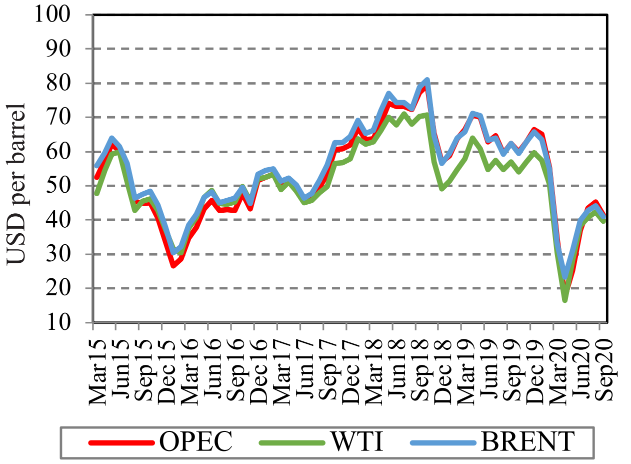
International oil prices (Brent crude and OPEC) averaged slightly above USD40 per barrel in the third quarter of 2020 (Chart 3.15). The OPEC reference crude oil basket price and the Brent crude increased by 58.9 percent and 34.1 percent, from an average of USD26.82 per barrel and USD31.44 per barrel in the second quarter of 2020 to an average of USD42.61 per barrel and USD41.24 per barrel, respectively, in the third quarter of 2020. The price of the West Texas Intermediate (WTI)[16] also increased by 45.3 percent from an average of USD27.95 per barrel to an average of USD40.61 per barrel in the same period. International oil prices increased in part, due to expansion in demand associated with relaxation of lockdowns in many countries. The increase in oil prices was also in response to enhanced prospects for development and availability of a COVID-19 vaccine in the short term, as positive results in vaccine trials outweighed concerns over a resurgence in virus cases.

Oil prices hit a 5-month low on November 2, 2020, as countries re-imposed lockdowns due to rising

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

COVID-19 infection rates; the OPEC basket price was USD35.89 per barrel. However, prices have since recovered to over USD40 per barrel, buoyed by the positive developments on a COVID-19 vaccine. In November 2020, the OPEC reference crude oil basket, Brent crude and WTI averaged USD43.22, USD43.53 and USD41.10 per barrel, respectively.

Chart 3.15: Oil Prices (monthly averages)

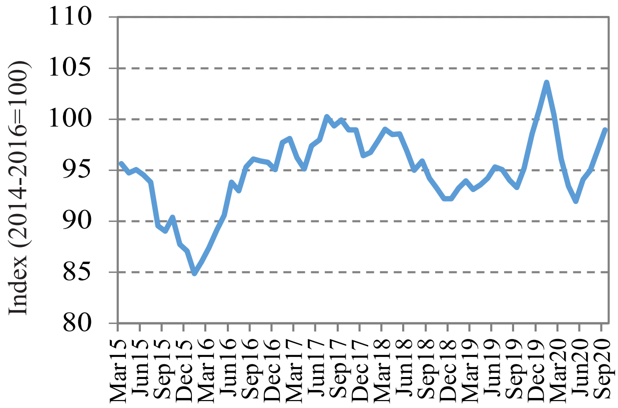


Source: OPEC and US Energy Information

Food prices increased in the third quarter of 2020

According to the United Nations Food and Agriculture Organisation (FAO), the global food price index averaged 96.9 points in the third quarter of 2020, a 3.2 percent increase from an average of 94.4 points in the corresponding period in 2019 (Chart 3.16). The increase in prices was attributable to higher vegetable oil prices. Moreover, brisk trade activity supported by the recovery in global demand following relaxation of some COVID-19 containment measures put some impetus on food prices. Furthermore, the increased concerns over production in the Southern hemisphere and dry conditions in many parts of Europe resulted in overall higher food prices. Meanwhile, the food price index averaged 100.5 points in November 2020, an increase of 3.9 percent from October 2020, and 6.4 percent higher than in the corresponding period last year. This marked the highest increase since December 2014, as all sub-indices rose in November 2020, with the vegetable oil price rising the most.

Chart 3.16: Food Price Index

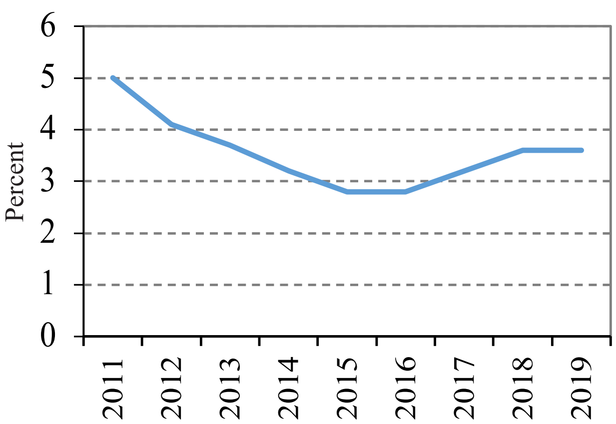


Source: Food and Agriculture Organisation

Global inflation remains low

Global inflation remains low, owing to subdued global economic demand. Inflation increased from 0.7 percent in the second quarter to 1 percent in the third quarter of 2020 for advanced economies. Conversely, inflation decreased from 3 percent to 2.8 percent in emerging market economies in the same period. Global inflation was unchanged at 3.6 percent in 2018 and 2019 (Chart 3.17).

Chart 3.17: Global Inflation

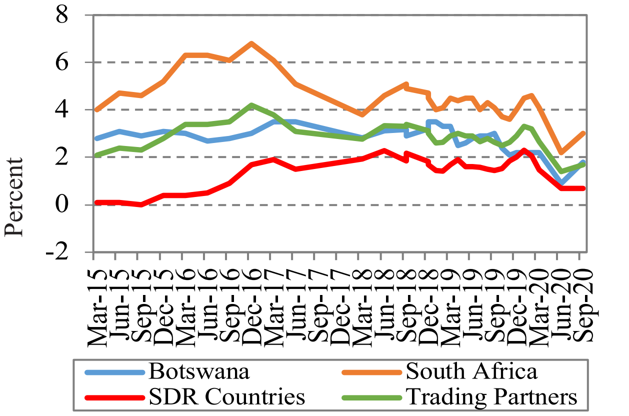


Source: IMF October 2020 WEO

In South Africa, headline inflation averaged 4.1 percent in 2019, lower than the 4.6 percent in 2018. Inflation increased from 3 percent in September 2020 to 3.3 percent in October 2020, falling within the SARB's target range of 3 – 6 percent.

The average trade-weighted inflation for Botswana's trading partners (Chart 3.18) was constant at 1.8 percent between September and October 2020.

Chart 3.18: 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 3.6), the European Central Bank (ECB) maintained the deposit rate, refinancing rate and lending rate at -0.50 percent, zero percent and 0.25 percent, respectively, as the Committee took a wait-and-see approach until a new round of economic forecast is released in December 2020. This will allow a thorough reassessment of the economic outlook and the balance of risks. The ECB pledged to recalibrate its instruments as appropriate, to respond to the unfolding situation and ensure that financing conditions remain favourable to support economic recovery and to counteract the negative impact of the pandemic on the projected inflation path. With a view to support economic activity, the ECB maintained the pandemic emergency purchase programme (PEPP) at €1350 billion. The net purchases under PEPP would be made to the end of June 2021, with maturing purchases reinvested until at least the end of 2022. The ECB also continued with asset purchases at a monthly pace of €20 billion under its asset purchase programme (APP), along with additional net asset purchases of €120 billion that are earmarked to end in December 2020.

At the November 2020 meeting, the US Federal Open Market Committee (FOMC) left the US Federal Funds Rate range unchanged at 0 – 0.25 percent, amidst uncertainty associated with the outturn of the US presidential elections. The Committee indicated that it would maintain the target range until it was confident that the economy had weathered recent events and was on track to achieve its maximum employment and price stability goals. In addition, the Fed indicated that it would increase its holdings of Treasury securities and agency mortgage-backed securities over the coming months to sustain the smooth functioning of the market. The Fed also announced that it stands ready to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of its goals.

The Bank of England (BoE) maintained the Bank Rate at 0.1 percent and increased the size of its total stock of asset purchases by a larger-than-expected £150 billion to £875 billion in November 2020, as the country entered a new lockdown to contain the increase in COVID-19 infections. The BoE judged that the path of growth and inflation would depend on the evolution of the COVID-19 pandemic and measures taken to protect public health, as well as the nature of, and transition to the new trading arrangements between the European Union and the UK. The BoE expected CPI inflation to remain below 1 percent until early 2021, largely reflecting the dampening effects of the COVID-19 pandemic.

The Bank of Japan (BoJ) kept its key short-term interest rate unchanged at -0.1 percent and maintained long-term government bond yield at around zero percent during its October 2020 meeting. In addition, the BoJ agreed to purchase exchange-traded funds (ETFs) and Japan real estate investment trusts (J-REITs) so that their amounts outstanding will increase annually to about 12 trillion yen and about 180 billion yen, respectively.

In emerging market economies, the SARB maintained the repo rate at 3.50 percent in November 2020, as risks to the growth and inflation outlook were assesed to be balanced in the medium term.The SARB expected inflation to be contained and to remain below the 4.5 percent midpoint of the target range in 2020, due to the economic contraction and slow recovery. The SARB noted that monetary policy had eased financial conditions and improved the resilience of households and businesses to the economic impact of COVID-19, while ensuring adequate liquidity in the domestic markets. In addition, the SARB indicated that there would be no further easing of policy in the near term, but provided forward guidance that two repo rate hikes in the third and fourth quarters of 2021 were highly likely.

The Central Bank of Russia (CBoR) maintained the key rate at 4.25 percent in October 2020, as inflation was in line with the Bank's forecast and expected to be within the range of 3.5 – 4 percent at the end of 2020. The CBoR signalled the possibility of further easing going forward. Similarly, the Central Bank of Brazil maintained the policy rate at an all-time low of 2 percent in October 2020, following a cumulative 250 basis points cut since the beginning of 2020. It indicated that economic recovery continued and the inflation outlook was positive.

The People's Bank of China (PBoC) maintained the one-year Loan Prime Rate for the seventh consecutive month at 3.85 percent in November 2020, amid efforts to maintain accommodative monetary conditions in support of the economic recovery from the COVID-19 pandemic disruption. Similarly, the Reserve Bank of India (RBI) maintained the policy rate at 4 percent in October 2020 and the reverse repo rate at 3.35 percent. The RBI indicated that it would start availing the real-time gross settlement (RTGS) facility from December 2020 for swift payments to improve the ease of doing operations.

Table 3.6: Monetary Policy Decisions

Central Bank	Latest Meeting	Current Policy Rate (Percent)	Change from Previous Meeting
Bank of Botswana	December 2020	3.75	No change
SARB	November 2020	3.50	No change
US Federal Reserve	November 2020	0 – 0.25	No change
BoE	November 2020	0.10	No change
ECB	October 2020	0.00	No change
BoJ	October 2020	-0.10	No change
PBoC	November 2020	3.85	No change
Brazil	October 2020	2.00	No change
India	October 2020	4.00	No change
Russia	October 2020	4.25	No change

Source: Various central banks' websites

4. THE ECONOMIC AND POLICY OUTLOOK

4.1 Global economic prospects

The global economic outlook has been revised upwards, on account of better-than-anticipated performance for the second quarter, particularly in advanced economies and the expected continued recovery in the third quarter of 2020. Meanwhile, prospects for EMDEs are much weaker owing to the spread of the pandemic and its impact on the health system and important sectors, such as tourism. Regionally, in South Africa, the growth outlook is projected to remain subdued, mainly attributable to resumption of power cuts resulting from increased demand following the easing of lockdown restrictions, as well as fears of the resurgence of COVID-19 in the fourth quarter of 2020. With regard to price developments, global inflation is forecast to decline from 3.5 percent in 2019 to 3.2 percent and 3.4 percent in 2020 and 2021, respectively, consistent with the subdued global demand owing to income losses amid the COVID-19 pandemic and the anticipated fall in international oil prices.

Global economic outlook revised upwards

According to the October 2020 WEO, global output is forecast to contract by 4.4 percent in 2020, 0.5 percentage points higher than the June 2020 projections, reflecting better-than-anticipated growth in the second quarter, particularly in advanced economies, as well as indications of continued stronger recovery in the third quarter of 2020. Similar to the June 2020 projections, all regions are projected to experience negative growth in 2020. Global economic growth is expected to rebound to 5.2 percent (0.2 percentage points lower than in the June 2020 WEO Update) in 2021, consistent with expectations of persistent social distancing which will weigh on economic activity.

For advanced economies, output growth is forecast to contract by 5.8 percent in 2020, from 1.7 percent in 2019. The 2020 projection is an improvement by 2.3 percentage points from the June 2020 WEO Update, reflecting the better-than-foreseen GDP outturns in the US and Euro area in the second quarter. Growth in advanced economies is projected to rebound to 3.9 percent in 2021 supported by fiscal and financial countermeasures deployed by several countries since the beginning of the pandemic. However, the 2021 projection is 0.9 percentage points lower than in the June 2020 WEO Update due to the sustained effect of social distancing measures put in place to contain the increase in COVID-19 infections, resulting in weaker private consumption and a rise in precautionary saving.

Overall, risks to global output remain skewed to the downside. They include possible recurrence of outbreaks in places that have gone past peak infection, as well as uncertain adequacy, distribution mechanism and public acceptance resulting in protracted restrictions on economic activity.

UK economy to contract in 2020

The UK economy is expected to contract by 9.8 percent in 2020 (0.4 percentage points less contraction than in the June 2020 WEO Update), compared to an expansion of 1.5 percent in 2019, mostly due to the anticipated lasting consequences of COVID-19, continuing uncertainty about the UK's future trading relations with the EU, as well as net trade that is expected to continue weighing down on growth. Furthermore, the newly implemented lockdown aimed at containing the resurgence of COVID-19 infections is expected to also weigh on the economy. However, economic growth is expected to pick up to 5.9 percent in 2021, supported in part by policy stimulus.

Output growth for US to decline

For the US, output is forecast to decline by 4.3 percent in 2020, before expanding to 3.1 percent in 2021, from the growth of 2.2 percent in 2019. However, the 2020 projection is an upward revision by 3.7 percentage points compared to the June 2020 forecast, as the fiscal and monetary stimulus in place are expected to offset the detrimental effects of COVID-19.

Growth for the euro area to contract

In the euro area, economic activity is projected to contract by 8.3 percent in 2020 (1.9 percentage points higher compared to the June 2020 WEO Update) from the growth of 1.3 percent in 2019. Growth forecasts for 2020 of all the major economies in the economic bloc have been revised upwards, reflecting the better-than-foreseen GDP outturns in the second quarter of 2020. However, the recent lockdowns across the region are anticipated to delay economic recovery. Output for 2021 is forecast to grow by 5.2 percent, 0.8 percentage points lower than in the June 2020 WEO Update.

Emerging markets GDP expansion projected to be lower

Economic activity in emerging market and developing economies is projected to contract by 3.3 percent in 2020, from an estimated expansion of 3.7 percent in 2019. The 2020 economic performance has been revised downwards by 0.2 percentage points relative to the June 2020 WEO Update. The revision reflects among others; domestic disruptions to economic activity due to COVID-19; an overwhelmed healthcare system amid the continued spread of the COVID-19 virus in the region; the greater importance of severely affected sectors, such as tourism; a significant fall in commodity prices, which would severely impact on economic activity for commodity exporters; and the greater dependence on external finance, including remittances.

In China, prospects are much stronger than for most countries in the region, supported by policy stimulus and resilient exports, hence an upward revision of 0.9 percentage points to an expansion of 1.9 percent for 2020, relative to the June 2020 Update forecast. In India, the downward revision of 5.8 percentage points for 2020 reflects the weaker outlook for growth in domestic demand than previously envisaged as the country struggles to contain the pandemic and its detrimental effects on economic activity.

Growth in the South African economy to contract significantly

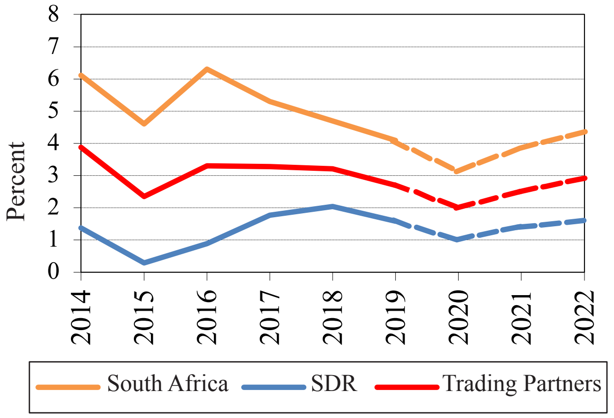
Growth prospects in South Africa are expected to remain constrained by the on-going COVID-19 global pandemic crisis, pre-existing electricity supply shortages, and sluggish demand as a result of weaker business confidence. Therefore, South African output is forecast to contract by 8 percent in 2020, but to rebound to a growth of 3 percent in 2021, compared to 0.2 percent growth in 2019. The forecast for 2020 is unchanged from the June projection but 0.5 percentage points lower for 2021. Meanwhile, in November 2020, the SARB revised forecasts of GDP growth for 2020 and 2021 to -8 percent and 3.5 percent, from -8.2 percent and 3.9 percent, respectively.

Global inflation to be moderate

Globally, there are indications of disinflationary pressures in 2020, emanating from slower global output growth against the backdrop of disruption in supply chains due to the pandemic that hampered both global economic activity and demand. In the short term, supply chain bottlenecks are expected to put upward pressure on prices of some goods and services but this could be broadly offset by weaker demand-side pressures underpinned by shorter working hours, cancellation of some scheduled purchases of goods and services and eminent lockdowns across the world. Global inflation is forecast at 3.2 percent and 3.4 percent in 2020 and 2021, respectively, from 3.5 percent in 2019. In advanced economies, disinflationary pressures are expected to mount, mainly due to the anticipated lower inflation in the US and euro area, which are currently experiencing high cases of infections and deaths occasioned by COVID-19. Similarly, for emerging market economies, inflation is expected to decrease in 2020, consistent with slowdown in growth of final demand and lower commodity prices.

Meanwhile, South African inflation is forecast to average 3.2 percent in 2020, 0.1 percentage points lower than the September 2020 forecast by SARB, mainly reflecting weaker domestic economic activity amidst the COVID-19 pandemic, as well as subdued global inflationary pressures. Overall, inflation is anticipated to remain within the SARB's target range but below the midpoint in 2021 (Chart 4.1).

Chart 4.1: South Africa and SDR Healine Inflation



Source: SARB and Bloomberg

Diamond prices expected to be subdued

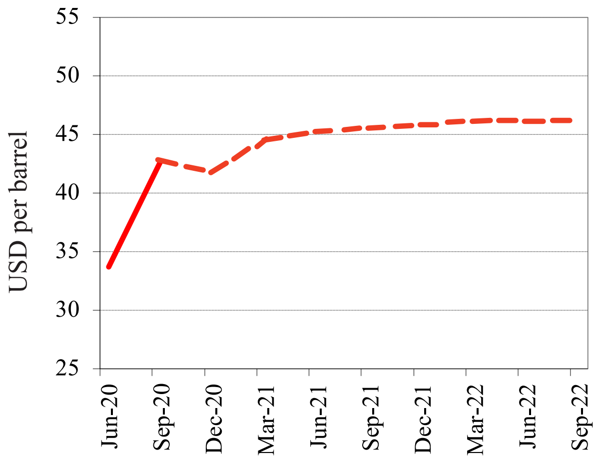
Global rough diamond prices are expected to be subdued in the last quarter of 2020, in the aftermath of the outbreak of COVID-19. Social distancing and the enhanced workplace safety standards are expected to persist into 2021 thus affecting both the demand and supply of rough diamonds. In addition, the recently reinstated lockdowns and other containment measures in the wake of a resurgence in COVID-19 infections will weaken demand prospects further, thus exerting disinflationary pressure on diamond prices. Moreover, the increase in polished diamond inventories due to weak global demand and lack of funds resulting from late repayments by diamond traders in countries adversely affected by the pandemic is anticipated to add downward pressure on diamond prices.

Likewise, polished diamond prices as well as diamond jewellery prices are expected to fall in the last quarter of 2020 and into 2021 as prospects for global end-consumer demand remain restrained. The lockdowns in the cutting and polishing industry in India are also expected to slow down the polished diamonds and jewellery sales. Risks to the global diamond industry are skewed to the downside, in the context of uncertainty surrounding the spread of the COVID-19. Lack of repayments by diamond traders in China and Hong Kong also poses massive liquidity risk to the diamond cutting and polishing industry.

International oil prices expected to moderate

International oil prices are projected to decrease in the near term, (Chart 4.2), mainly due to the re-imposition of travel restrictions and lockdowns to contain the resurgence in COVID-19 infections, which would lead to a decrease in demand for oil by both air and road transport users. However, improved prospects on demand for oil due to positive results in vaccine trials are expected to have an offsetting effect. Overall, developments in the international oil market imply downward pressure on domestic inflation in the near term.

Chart 4.2: International Oil Prices

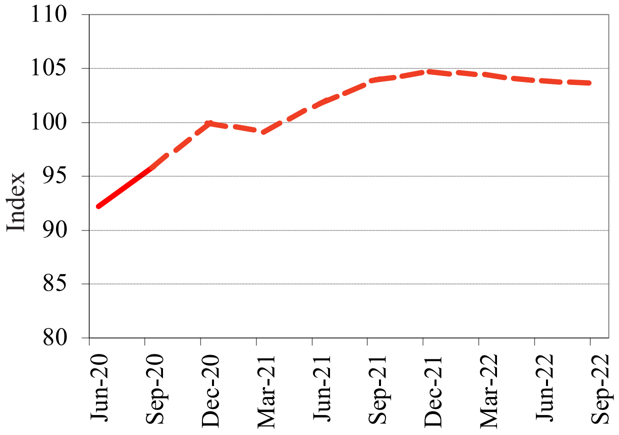


Source: Bloomberg

Global food prices to increase

Global food prices are 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 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. From a consumer basket persepective, prices are also expected to rise temporarily supported by the projected decrease in exports volumes in the short term, with some major food producing countries imposing export quotas in response to the COVID-19 workplace safety measures that have significantly affected inductrial production across the globe. Overall, there is potential upward pressure from international food prices on domestic inflation.

Chart 4.3: International Food Prices FAO Index



Source: Bloomberg

4.2 Outlook for domestic economic activity

GDP is expected to contract in 2020 compared to the 4.4 percent pre-COVID-19 projection. However, 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 the implementation of the ERTP, would generally be positive for economic activity in the medium term, although the economy would continue to operate below its potential.

Lower growth expected in domestic output

Before the outbreak of COVID-19, real GDP growth for 2020 was projected to expand by 4.4 percent. However, given the downside risks to global economic activity, mainly emanating from the outbreak of COVID-19, global demand and commodity prices (including for rough diamonds) have fallen, thereby dampening future economic performance. For Botswana, the pandemic poses added uncertainty and challenges given Botswana's high vulnerability to external shocks, notably, diamond production and demand, tourism and possible disruption of imported supplies either from South Africa or through South African ports of entry.

In line with these anticipated global developments, growth forecasts for the domestic economy by the MFED have been revised downwards. GDP is, therefore, projected to decline by 8.9 percent in 2020, from an earlier forecast of 13.1 percent contraction, before rebounding to 7.7 percent in 2021. The decline is attributed to the expected sharp contraction in output of major economic sectors, such as trade, hotels and restaurants (-27.4 percent); mining (-24.5 percent); construction (-6 percent); manufacturing (-3.9 percent); and transport and communications (-2.5 percent). Box 4 outlines Bank of Botswana's response to COVID-19.

Regarding quarterly activity, the domestic economy is expected to perform better in the third quarter of 2020 compared to the second quarter given the gradual easing of COVID-19 movement restrictions in the third quarter, and the significant increase in Debswana production in the quarter (4.8 million carats) compared to the previous quarter (1.8 million carats).

The Bank's September 2020 Business Expectations Survey (BES) indicates that firms were less pessimistic about economic activity in the third quarter of 2020 compared to the previous quarter. This is consistent with the gradual easing of COVID-19 movement restrictions in the third quarter of 2020 compared to the previous quarter. Therefore, non-mining activity is anticipated to improve in the short term although continuing to operate below potential into the medium term. Meanwhile, the IMF forecasts the domestic economy to contract by 9.6 percent in 2020 before rebounding to 8.6 percent in 2021.

Box 4: 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 December 3, 2020, 12 058 total cases (1 532 transferred out, 10 526 local cases, 1 090 active cases, 9 400 local recoveries and 36 local deaths) had been 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, which was later extended by another six months to April 2021, to allow the country to adequately respond to the threat posed by COVID-19. The lockdown was extended to May 20, 2020, after which, was replaced by a zoning strategy combined with thirteen check points between zones. Meanwhile, the greater Gaborone zone was put under a two-week lockdown effective midnight of June 30, 2020, following an announcement of 30 new cases in one day in the capital city.

As an open economy that is integrated with regional global economies, Botswana is affected through several channels, among others, local infections; weaker global demand affecting exports (diamonds and tourism, for example); disruption to global supply chains affecting local production and project execution; and disruptions caused by containment and mitigation measures imposed by Government. Other channels include the impact of disruption of economic activity on the banking system and likely reduction in fiscal and external buffers; as well as the weak performance of, and panic, in the global markets that, invariably, will negatively impact on the nation's official foreign exchange reserves, while the MFED projects a sharp deterioration of 8.9 percent contraction and a modest recovery of 7.7 percent growth in 2021.

- Bank of Botswana (the Bank) has undertaken the following measures to alleviate the adverse impact of COVID-19 on the Botswana economy: The Bank will maintain uninterrupted supply and availability of clean banknotes and coin, as well as banking services, primarily to Government and commercial banks.

- With a view to support the banking system, the Bank offered capital relief and support for commercial banks to enable them to satisfy capital requirements and address liquidity challenges as they continue to support economic activity under conditions of possible increase in credit defaults and impairments as well as the need for additional lending. In this regard, since April 2020:

  - The prudential capital adequacy ratio for commercial banks operating in Botswana has been reduced from 15 percent to 12.5 percent; and

  - To alleviate any possible pressure on the commercial banks and extend potential additional sources of liquidity, the following measures have been 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;

    - Repo facilities currently available only on an overnight basis will be 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.

    - In addition, consistent with provisions of the Electronic Payments Services Regulations, the limits on mobile money transactions have been raised as follows: maximum single transaction, from P5 000 to P10 000; maximum daily transaction, from P10 000 to P15 000; and maximum monthly aggregate, from P20 000 to P30 000.

- The Bank Rate has been reduced by a cumulative 100 basis points in 2020. The Bank Rate was reduced by 50 basis points from 4.75 percent to 4.25 percent, and the PRR from 5 percent to 2.5 percent on April 30, 2020, in the context of a suppressed medium-term inflation outlook, associated with subdued domestic demand resulting from the adverse effects of the lockdowns occasioned by the outbreak and subsequent spread of COVID-19. A further reduction by 50 basis points was made on October 8, 2020 in the context of prospects for low inflation in the medium term.

Given that the full extent of economic and financial disruption from COVID-19 is yet to be established, the measures and changes undertaken by the Bank will continue to be revised as the need arises.

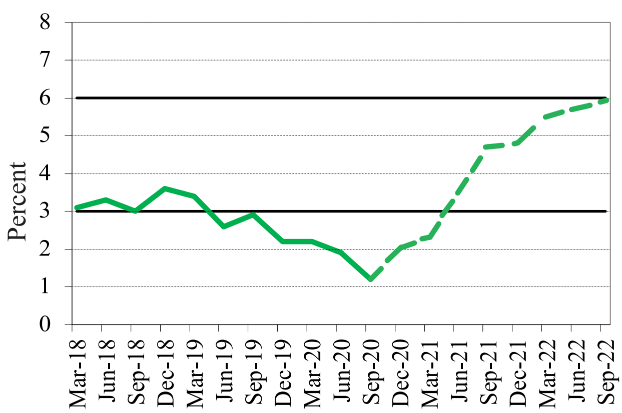
4.3 Monetary policy and the inflation outlook

Inflation is forecast to remain below the lower bound of the Bank's 3 - 6 percent objective range in the short term. However, inflation is expected to revert to within the objective range in the second quarter of 2021. Compared to the October 2020 forecast, inflation is projected to be higher in the short to medium term, reflecting the more accommodative monetary conditions, the expected upward adjustments in VAT and private school fees, as well as the upward revision in forecasts for international food prices. Overall, risks to the inflation outlook are assessed to be balanced. Upside risks relate to the potential increase in international commodity prices beyond current forecasts, aggressive policy actions to bolster demand, as well as the anticipated supply constraints due to travel restrictions and lockdowns, though abating. Domestically, accelerated implementation of the ERTP, as well as a possible increase in government levies and/or taxes, could lead to higher inflation. These risks are moderated by weak domestic and global economic activity, which could be exacerbated by periodic lockdowns due to prolonged COVID-19 infections, as well as the possible decline in international commodity prices. Furthermore, should there be implementation capacity constraints, this could hinder the effectiveness of the policy stimulus and ERTP initiatives, thus resulting in lower inflation.

Inflation projected to remain below the objective range in the short term

Inflation is forecast to remain below the lower bound of the Bank's 3 - 6 percent objective range for the remainder of 2020 and the first quarter of 2021 (Chart 4.4).

Chart 4.4: Botswana Headline Inflation Forecast



Source: Bank of Botswana

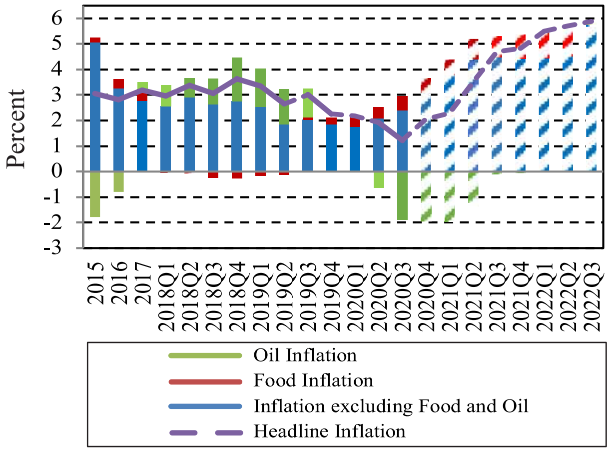
The subdued inflation in the near term mainly reflects the significant downward adjustment of domestic fuel prices in the second quarter of 2020, which is exacerbated by the expected downward adjustment in domestic fuel prices in the fourth quarter of 2020, and the disinflationary pressures anticipated from the adverse impact of the COVID-19 pandemic on both the domestic and global economic developments[17]. Nonetheless, inflation is expected to revert to within the objective range in the second quarter of 2021, reflecting the anticipated increase in domestic demand in response to the overall accommodative monetary conditions, and implementation of the ERTP by Government; the possible increase in government levies and/or taxes; the envisaged upward adjustments in VAT and electricity tariffs; the likely increase in international commodity prices; as well as base effects associated with the decrease in fuel prices in 2020. Meanwhile, according to the September 2020 BES, the business community expect inflation to be within the objective range in both 2020 and 2021.

Core inflation to increase in the short to medium term

Inflation excluding food and fuel prices is forecast to rise in the short to medium term, reflecting the projected increase in VAT and electricity tariffs in 2021 and 2022, as well as the expected improvement in non-mining output growth (Chart 4.5).

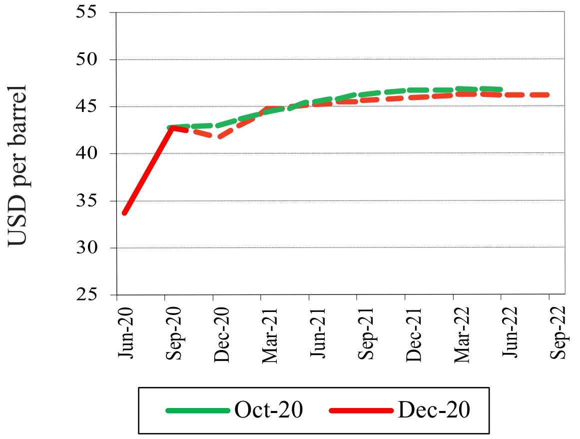
[17] The subdued inflation in the near term also reflects the downward revision in forecasts for South African inflation.

Chart 4.5: Headline Inflation and its Components



Source: Bank of Botswana

Chart 4.7: International Oil Prices

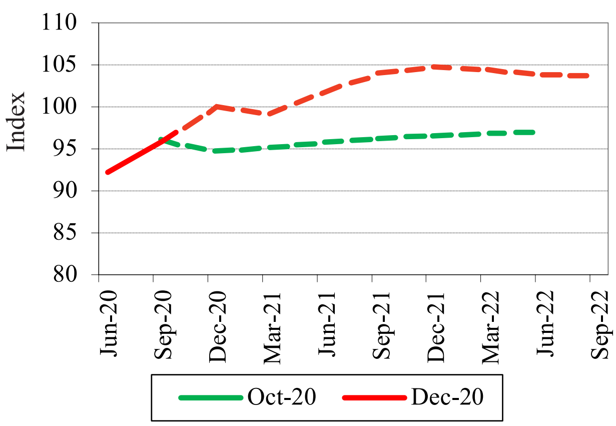


Source: Bloomberg

International food prices to increase

Compared to the October 2020 forecast, international food prices have been revised upwards in the short to medium term (Chart 4.6). The upward revision reflects the mismatch between increased demand and low supply of food.

Chart 4.6: International Food Prices FAO Index



Source: Bloomberg

International oil prices slightly revised downwards

Relative to the October 2020 projection, international oil prices indicate a slight downward revision in the trajectory (Chart 4.7). The slight downward revision in prices is due to the expected lower demand of oil as governments re-imposed mobility restrictions following resurgence of COVID-19 infections in several countries across the world. However, the downward pressure is moderated and offset by improved prospects on demand for oil amid optimism around developments on COVID-19 vaccine.

Overall, developments with respect to international oil and food prices imply upward pressure on domestic inflation with the food category carrying a relatively larger weight of 13.55 percent compared to 10.03 percent for the oil category in the CPI basket.

Inflation forecast revised upwards in the short to medium term

The December 2020 inflation forecast has been revised upwards in the short to medium term compared to the October 2020 forecast. The higher inflation trajectory is on account of the more accommodative monetary conditions, the expected upward adjustments in VAT and private school fees, as well as the upward revision in forecasts for international food prices.

Exchange rate movements

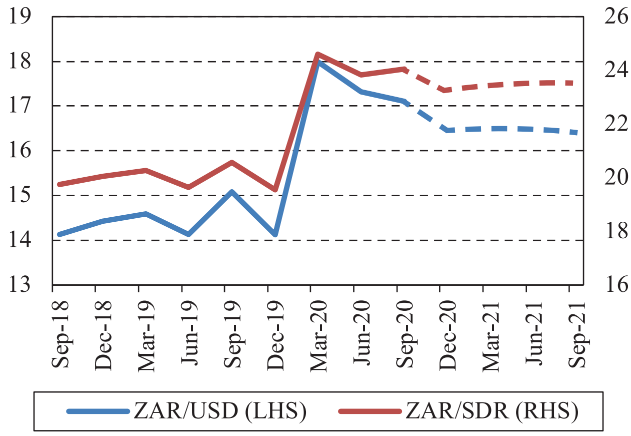
The Pula exchange rate is determined by the performance of the Pula basket currencies and the rate of crawl. Once the basket composition and the rate of crawl (based on inflation differentials) have been determined, the daily changes in the value of the Pula against other currencies are a result of movements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

The South African rand is expected to appreciate marginally against major currencies in the next four quarters (Chart 4.8) due to increasing investor risk appetite as the global economy gradually recovers, as well as the expected improvement in economic output in South Africa’s key sector as the spread of COVID-19 infections subsides in the

South African economy. The South African rand is also expected to be boosted by the successful production of the COVID-19 vaccine as well as the envisaged additional US fiscal spending, which is expected to lower returns on long-term US government bonds thus supporting carry trade in favour of high-yielding emerging market assets. However, external factors such as the slower pace of global growth, the possible resurgence of COVID-19 infections, and the unfavourable changes in investor sentiment towards emerging-market assets are expected to continue to weigh on the South African rand. Internally, concerns over the domestic economic growth in the short to medium term, amid weak economic fundamentals, are also expected to limit full recovery of the rand.

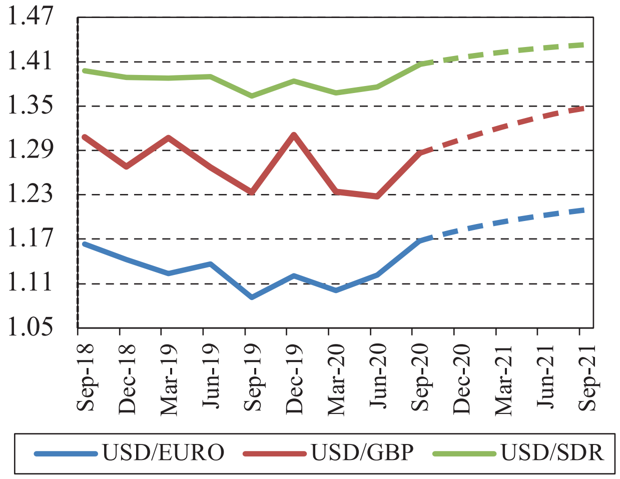
In response to the threat of a global recession posed by the spread of COVID-19, central banks across the world, including the SARB have engaged in providing further monetary accommodation, as well as providing liquidity support to ensure smooth functioning of markets. Therefore, monetary policy easing in developed economies is expected to benefit the South African rand against the US dollar, despite the fragile domestic economic outlook, since investors seek high yielding assets, such as the rand.

Chart 4.8: ZAR against USD and SDR



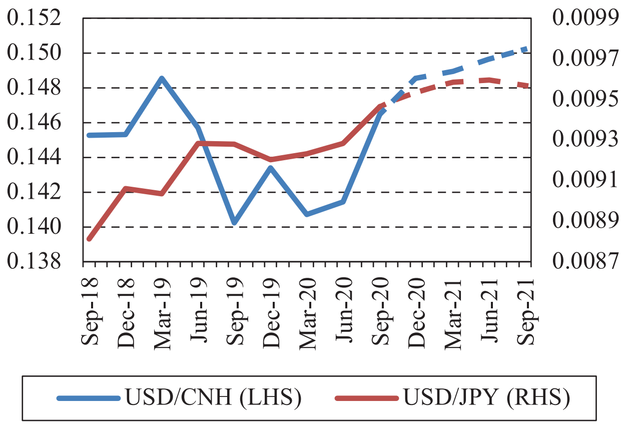
Source: Reuters

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 depreciate against most major international currencies in the next four quarters (Chart 4.9A and Chart 4.9B), due to the expected improvement in business and investor confidence as the world economy recovers from the adverse impact of COVID-19. Furthermore, hopes of a breakthrough in the US government stimulus package, as well as the expectations that the Fed will continue its unprecedented monetary support, zero rates, quantitative easing and the possible introduction of negative interest rates in the near future, are expected to continue to weigh on the US dollar. However, global uncertainty and market volatilty due to the impact of COVID-19 on the global economy is likely to influence investors to hold the world's most liquid currency, the US dollar, thus affecting this forecast.

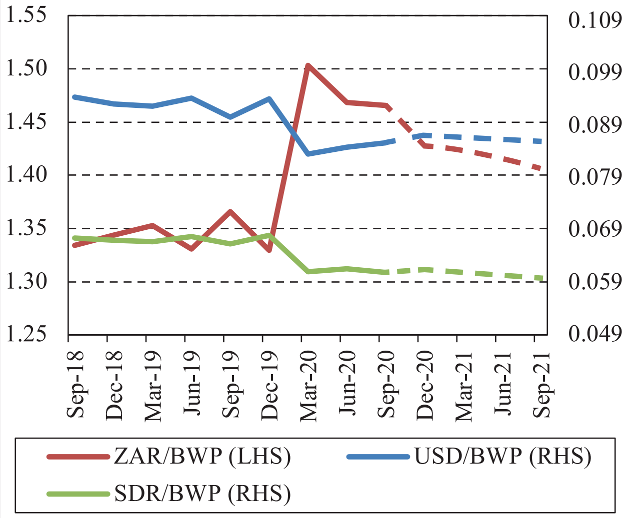
The British pound is expected to appreciate against the US dollar on the back of increasing global risk sentiment. The British pound outlook may be marred by Brexit uncertainty amid increasing signs that trade talks could be extended into next year. Furthermore, concerns about the spread of COVID-19 and increased illiquidity in the government bonds market, weigh on the forecast. Meanwhile, the euro is expected to appreciate against the US dollar owing to expectations that the Euro zone economic growth will be slightly stronger than previously projected, after European Union leaders agreed on 750 billion euros to support economies ravaged by the coronavirus.

The Japanese yen is expected to be relatively stable against the US dollar due to its safe-haven status. However, measures taken by the Fed and the Bank of Japan to cushion the effects of the pandemic, as well as Japan's negative economic outlook are likely to affect this forecast.

The Chinese renminbi is expected to appreciate against the US dollar in the next four quarters (Chart 4.9B) as business activity in China is expected to recover faster from COVID-19 and suffer less economic impairment than the rest of the world. The expectation is partly attributable to the policies that the PBoC currently has, as well as its ability to direct the dynamics of its credit impulse. Since the COVID-19 outbreak, the PBoC has deviated from the trend of asset purchases (as is the case in many developed and some emerging markets economies), instead, it has focused on the credit channel to stimulate the economy.

Overall, forecast movements of the SDR constituent currencies would result in the appreciation of the SDR against the US dollar (Chart 4.9A). Even though the rand is forecast to appreciate against the SDR constituent currencies, the Pula is expected to depreciate against the SDR constituent currencies and the rand in the next twelve months (Chart 4.10). The projected depreciation of the Pula against the rand is expected to exert marginal upward pressure on the domestic inflation.

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



Source: Reuters and BoB calculations

Risks are balanced

The overall risks to the inflation outlook are assessed to be balanced. Upside risks relate to the potential increase in international commodity prices beyond current forecasts, aggressive action by governments and major central banks to bolster demand, as well as the anticipated supply constraints due to travel restrictions and lockdowns, though abating. Domestically, accelerated implementation of the ERTP, as well as a possible increase in government levies and/or taxes, could lead to higher inflation. These risks are moderated by weak domestic and global economic activity, which would be exacerbated by periodic lockdowns due to prolonged COVID-19 infections, and the possible decline in international commodity prices. Furthermore, should there be implementation capacity constraints, this could hinder the effectiveness of policy stimulus and ERTP initiatives, thus resulting in lower inflation.

5. DECEMBER 2020 MONETARY POLICY COMMITTEE DECISION

At the meeting held on December 3, 2020, the Monetary Policy Committee (MPC) of the Bank of Botswana decided to maintain the Bank Rate at 3.75 percent. Inflation increased from 1.8 percent in September to 2.2 percent in October 2020 and remained below the lower bound of the Bank's objective range of 3 – 6 percent. However, inflation is forecast to revert to within the objective range in the second quarter of 2021.

Overall, risks to the inflation outlook are assessed to be balanced. Upside risks relate to the potential increase in international commodity prices beyond current forecasts, aggressive action by governments and major central banks to bolster demand, as well as possible supply constraints due to travel restrictions and lockdowns, though abating. Domestically, accelerated implementation of the Economic Recovery and Transformation Plan (ERTP), as well as a possible increase in government levies and/or taxes, could lead to higher inflation. These risks are moderated by weak domestic and global economic activity, which could be exacerbated by periodic lockdowns due to prolonged COVID-19 infections, and the possible decline in international commodity prices. Furthermore, should there be implementation capacity constraints, this could hinder the effectiveness of policy stimulus and ERTP initiatives, thus resulting in lower inflation.

Real Gross Domestic Product (GDP) contracted by 4.2 percent in the twelve months to June 2020, compared to a growth of 3.9 percent in the corresponding period in 2019. The decline in output is attributable to the contraction in output of both mining and non-mining sectors, resulting from the associated COVID-19 pandemic containment measures. Mining output contracted by 18.6 percent compared to a growth of 1.5 percent in the corresponding period in 2019, mainly due to weaker performance of the diamond, soda ash, copper and other mining subsectors. Non-mining GDP contracted by 2.6 percent in the year to June 2020 compared to 4.2 percent in the same period in 2019. The lower growth in non-mining GDP was mainly due to contraction in output of the trade, hotels and restaurants, transport and communications, construction and manufacturing sectors. In addition, the deceleration in growth of the finance and business services, general government, agriculture and social and personal services contributed to the overall output decline of the non-mining sector.

Projections by the Ministry of Finance and Economic Development and the International Monetary Fund (IMF) suggest a deterioration in economic growth for Botswana in 2020. The Ministry estimates that the economy will decline by 8.9 percent in 2020, from an earlier forecast of a 13.1 percent contraction, before rebounding to growth of 7.7 percent in 2021. The IMF forecasts the domestic economy to contract by 9.6 percent in 2020 compared to 5.4 percent in the April 2020 World Economic Outlook, before recovering to a growth of 8.6 percent in 2021. Even with recovery in 2021, the contraction in 2020 equates, approximately, to a two-year loss of growth in output. The disparity in forecasts attest to the challenges of making forward projections when there is uncertainty about the duration of constrained economic activity, the resultant adverse impact on productive capacity, as well as the speed of resumption of production and pace of recovery in demand.

Broadly, the contraction in GDP reflects the substantial curtailment of economic activity due to the necessary measures implemented to contain the spread of COVID-19 and safeguard human life. The resultant decrease in global demand and disruption in supply chains, as well as curtailed economic activity locally, has affected several sources of economic growth for Botswana. Notably, these include exports, such as minerals and tourism as well as non-food retail economic activity. Nonetheless, the economy is expected to have performed better in the third quarter of 2020 compared to the second quarter given the gradual easing of COVID-19 movement restrictions from that period, and the significant increase in Debswana production in the second half compared to the first half of the year.

Meanwhile, economic activity in South Africa remains subdued and the South African Reserve Bank projects GDP to contract by 8 percent in 2020, but to recover to a growth of 3 percent in 2021. Global output is projected to contract by 4.4 percent in 2020 but to rebound to 5.2 percent in 2021, anchored by better performance than anticipated for the second quarter of 2020, a stronger performance in the third quarter, as well as immense policy support. However, the recovery projections are fraught with uncertainty with respect to the possible resurgence in infections and uncertain availability and distribution of a COVID-19 vaccine. A similar pattern of developments pertains regarding Botswana.

The MPC, however, recognised that the short-term adverse developments in the domestic economy occur against a potentially supportive environment including accommodative monetary conditions; reforms to further improve the business environment; concerted efforts by government to mitigate the impact of COVID-19; as well as the anticipated positive impact of the ERTP. These would generally augur well for economic activity in the medium term.

Therefore, 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 should the need arise.

The MPC meetings for 2021 are scheduled as follows:

February 25, 2021

April 29, 2021

June 17, 2021

August 19, 2021

October 21, 2021

December 2, 2021

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