Monetary Policy Statement 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;
- safe, sound and stable financial system;
- efficient payment 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.

MONETARY POLICY STATEMENT 2020

Moses D Pelaelo

Governor

February 25, 2020

17938 Khama Crescent, Gaborone; Tel: (267) 360-6000; Facsimile: (267) 390-9016

Website: www.bankofbotswana.bw

1. INTRODUCTION

1.1 The Monetary Policy Statement (MPS) is the main medium through which the Bank of Botswana (the Bank) informs stakeholders about the framework for the formulation and implementation of monetary policy. In this regard, the Bank, through the MPS, reviews inflation trends and policy performance and articulates the policy choices for the ensuing year. The Statement also serves to fulfil the public's expectation of a transparent and accountable central bank in pursuit of its monetary policy mandate, as set out in the Bank of Botswana Act (CAP 55:01).

1.2 The 2020 MPS, therefore, reports on the previous year's economic and policy developments and also evaluates the determinants of changes in the level of prices and their impact on inflation in Botswana. This entails an assessment of economic and financial developments that are likely to influence the inflation path in the medium term and the Bank's policy choices in 2020. Price developments and policy options are evaluated in the context of a forward-looking monetary policy framework, the Bank's medium-term inflation objective range of 3 – 6 percent and the financial stability objective. In this respect, the MPS promotes an understanding of prospective conduct of monetary policy in order to anchor public expectations on the objective of a low, predictable and sustainable level of inflation.

1.3 Global economic growth is estimated at 2.9 percent in 2019, lower than the expansion of 3.6 percent in 2018, with uneven progress across countries and regions. In general, global economic performance and sentiment were negatively affected by trade tensions between the US and China as well as uncertain prospects for Brexit, weighing down on trade and investment. In the circumstances, global inflation eased from 3.6 percent in 2018 to 3.4 percent in 2019.[1] Taking into account the sources of inflation and economic conditions, central banks in advanced economies maintained their ultra-accommodative monetary policy stance or reduced policy rates in 2019, with some continuing to provide liquidity support to the financial sector through various programmes. Meanwhile, in emerging market economies, most central banks reduced their policy rates to stimulate economic activity.

1.4 In Botswana, real Gross Domestic Product (GDP) grew by 3.7 percent in the twelve months to September 2019, compared to a faster growth of 5 percent in the year to September 2018; the weaker performance was mainly attributable to a smaller increase in mining output. Inflation was below the lower bound of the Bank's medium-term objective range for most of 2019, and was 2.2 percent in December 2019.[2] Overall, price developments were in the context of moderate domestic demand pressures resulting from the modest growth in personal incomes and modest increase in foreign prices.

1.5 The Bank maintained an accommodative monetary policy stance during 2019 in view of the positive inflation outlook in the medium term. The Bank Rate was, therefore, reduced from 5 percent to 4.75 percent in August 2019. The Bank also implemented an upward 0.3 percent annual rate of crawl of the nominal effective exchange rate (NEER) of the

---

1 Bloomberg data shows that inflation in advanced economies decreased from 2.3 percent in 2018 to 1.9 percent in 2019, and from 3.6 percent to 3.2 percent for emerging market economies in the same period.

2 Inflation breached the lower bound of the objective range in April (2.5 percent), May (2.6 percent), June (2.8 percent), July (2.9 percent), August (2.9 percent), October (2.4 percent), November (2.1 percent) and December (2.2 percent).

Pula in 2019, taking into account the expected inflation differentials between Botswana and its trading partner countries. Bilaterally, the Pula appreciated modestly against the Special Drawing Rights (SDR)[3], while depreciating against the South African rand.[4] The real effective exchange rate (REER) depreciated by 0.4 percent year-on-year to December 2019, due to lower inflation in Botswana than in trading partner countries, with the inflation differential being larger than the upward rate of crawl.

1.6 Notwithstanding the fact that in 8 of the 12 months of 2019, inflation breached the lower bound of the desired level, inflation is forecast to be within the 3 – 6 percent objective range in the medium term. Benign domestic demand pressures, associated with moderate increase in personal incomes, and the modest increase in foreign prices contribute to the positive inflation outlook. This outlook is subject to upside risks emanating from any unanticipated substantial upward adjustment in administered prices and government levies and/or taxes, as well as the potential increase in international commodity prices beyond current forecasts. However, possible weaker global economic activity and the tendency of technological progress to lower costs and prices (or dampen the rate of increase) present downside risks to the inflation outlook.

2. MONETARY POLICY FRAMEWORK

2.1 The primary objective of the Bank's monetary policy is to achieve price stability, which is defined as a sustainable level of inflation that is within the medium-term objective range of 3 – 6 percent. The policy is also formulated with a view to safeguarding the stability of the financial system. A low and predictable level of inflation and conducive monetary and financial conditions foster savings mobilisation, productive investment and international competitiveness of domestic producers which, in turn, contribute towards the broader national objectives of sustainable economic development and employment creation.

2.2 The monetary policy framework is forecast-based, with a medium-term outlook that primarily guides the Bank's response to projected movements in inflation, while taking into account prospects for economic growth and developments relating to stability of the financial system. To this end, in formulating an appropriate policy stance, the Bank factors in projections of real monetary conditions[5] in the context of other relevant domestic and international economic and financial developments, and their impact on the output gap[6] and, ultimately, inflation.

---

3 The SDR is the unit of account of the International Monetary Fund (IMF) that comprises the United States dollar, euro, Chinese renminbi (yuan), Japanese yen and British pound. Effective October 1, 2016, the respective weights are 41.73 percent, 30.93 percent, 10.92 percent, 8.33 percent and 8.09 percent.

4 Pula basket weights for 2019 were 45 percent for the South African rand and 55 percent for the SDR.

5 The real monetary conditions index (RMCI), which reflects the state of real monetary conditions, measures the relative looseness or tightness of monetary conditions and gauges the likely effect that monetary policy has on the economy through changes in the exchange rate and interest rates. The RMCI combines, through a weighted average, the deviations of the real exchange rate and real interest rate from their respective trend values.

6 The output gap refers to the difference between actual output and long-term trend output (as an indicator of the productive capacity of the economy). A negative (positive) output gap means the actual level of output for a given period is below (above) the trend level for that period, thus indicating that the economy is operating below (above) its estimated potential.

2.3 The Bank recognises the importance of communication in sustaining and reinforcing transparency, predictability and accountability with respect to the policy framework and actions; thus fostering market participation, influencing expectations, policy credibility and, consequently, policy transmission. In this regard, in addition to the MPS, the Bank publishes three Monetary Policy Reports in a year, following the April, August and December Monetary Policy Committee (MPC) meetings. Furthermore, the Bank publishes the MPC dates for the year ahead and the Governor delivers a statement at a press briefing subsequent to each meeting of the MPC to allow for engagement with the media and dissemination of the Bank's policy stance.

3. IMPLEMENTATION OF MONETARY POLICY AND RELATED ECONOMIC DEVELOPMENTS IN 2019

(a) External Developments

3.1 At the global level, monetary policy implementation varied in response to modest global growth and restrained inflation across countries and regions. Policymakers continued to focus on the need to achieve sustainable economic growth through facilitating access to finance in a stable environment. Monetary policy was accommodative in advanced economies, with low levels of interest rates and maintenance of liquidity support to the financial sector. Policy interest rates remained low in Japan and the euro area, while deposit interest rates were negative and asset purchase programmes were maintained in both jurisdictions.

3.2 In 2019, the Bank of England maintained the policy interest rate at 0.75 percent, in the context of reduced risk of a no-deal Brexit[7]. The US Federal Reserve (Fed) reduced the target range for the federal funds rate three times by a cumulative 75 basis points in 2019, to reach 1.5 - 1.75 percent in December 2019, as inflation remained subdued, while weaker business fixed investment and exports were associated with slowing growth momentum. In the emerging market economies, most central banks reduced their policy rates, mainly driven by the need to support economic activity. In South Africa, the repo rate was reduced by 25 basis points to 6.5 percent in July 2019,[8] while the Reserve Bank of India cut the policy rate by a cumulative 110 basis points to 5.15 percent in 2019, in response to continued downside risks emanating from the global economic slowdown and trade tensions. Brazil also eased the policy rate by a cumulative 200 basis points to 4.5 percent during the year to stimulate economic activity. Meanwhile, the People's Bank of China (PBoC) introduced the variable Loan Prime Rate (LPR) in August 2019, as the new benchmark for new bank loans in an attempt to reduce corporate borrowing costs.[9] It was initially set at 4.25 percent, and subsequently reduced by 10 basis points to 4.15 percent to boost the slowing economy. In addition, the PBoC reduced the reserve requirement ratio by 50 basis points to 10.5 percent during 2019 to support the real economy.

---

7 The UK exited the European Union (EU) as expected on January 31, 2020, and has entered a transition period until December 31, 2020 in which it will remain in both the EU customs union and single market.

8 The repo rate was reduced further by 25 basis points at the January 2020 MPC meeting, assessing that the risks to inflation were balanced while the lower inflation forecast provided some scope for further policy accommodation to the economy.

9 Previously, the PBoC used the fixed LPR benchmark, which was introduced in October 2013 and set at 4.31 percent.

3.3 GDP growth in advanced countries was subdued in 2019, as US economic expansion slowed from 2.9 percent in 2018 to 2.3 percent in 2019, due to the adverse impact of trade tensions between the US and China. Similarly, output growth in the euro area continued to be sluggish, easing from 1.9 percent in 2018 to 1.2 percent in 2019, among others, because of subdued domestic demand and the uncertainty surrounding Brexit. In Germany, weaker demand for the country's export-dependent manufacturing sector in the second half of 2019 led companies to scale down production and cut jobs, thereby contributing significantly to the decline in output growth from 1.5 percent in 2018 to 0.5 percent in 2019. Output expansion in the emerging market economies also decreased from 4.5 percent in 2018 to 3.7 percent in 2019, mainly influenced by slower growth of the Indian economy. In the circumstances, global GDP growth is estimated at 2.9 percent in 2019, lower than the 3.6 percent in 2018 (Table 3.1).

Table 3.1: Real GDP Growth Rates (Percent)

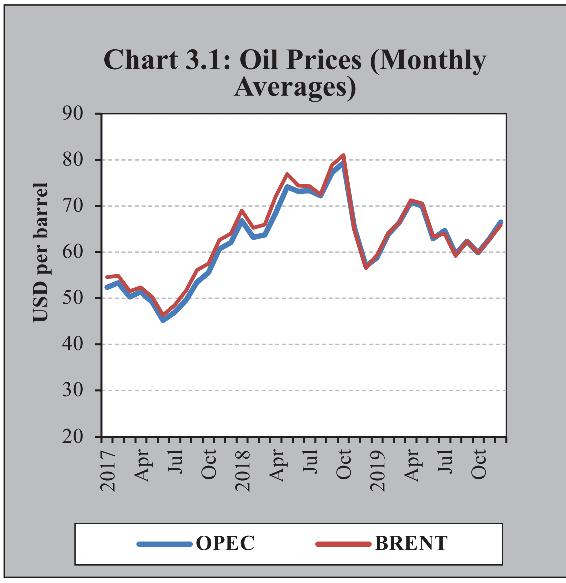
	Estimate		Projections
	2018	**2019**	**2020**
Global	**3.6**	**2.9**	**3.3**
Advanced economies	**2.2**	**1.7**	**1.6**
US	2.9	2.3	2.0
Euro area	1.9	1.2	1.3
UK	1.3	1.3	1.4
Japan	0.3	1.0	0.7
EMDEs	**4.5**	**3.7**	**4.4**
China	6.6	6.1	6.0
Brazil	1.3	1.2	2.2
India	6.8	4.8	5.8
Russia	2.3	1.1	1.9
South Africa	0.8	0.4	0.8
Botswana	**4.5**	**3.6**	**4.4**

Source: IMF, January 2020 World Economic Outlook (WEO) Update and Botswana's 2020 Budget Speech.

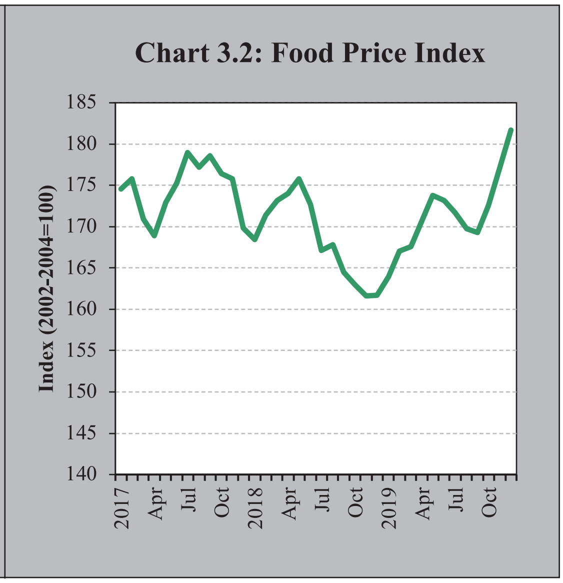
Note: EMDEs stands for emerging market and developing economies.

3.4 In 2019, global inflation decreased, partly due to subdued global demand and declining international oil prices. The price of the Organisation of the Petroleum Exporting Countries (OPEC) reference crude basket, Brent crude and West Texas Intermediate (WTI) fell by 7.9 percent, 7.8 percent and 10.5 percent to an average of USD64.04 per barrel, USD64.03 per barrel and USD57 per barrel in 2019, respectively (Chart 3.1).[10] The decrease in oil prices was influenced mainly by the heightened trade war between the US and China which resulted in lower global economic growth, thereby affecting the demand for oil. Overall, developments in international oil prices exerted modest downward pressure on domestic inflation in 2019. Meanwhile, international food prices increased by 1.8 percent in 2019 compared to a decrease of 3.5 percent in 2018 (Chart 3.2), driven by a significant rise in meat prices as the outbreak of African Swine Fever in East Asia dampened meat production. Consequently, meat prices increased by 5.7 percent in 2019 compared to a contraction of 2.3 percent in 2018.

10 The price of OPEC crude, Brent crude and WTI reached a low of USD59.52 per barrel, USD59.20 per barrel and USD54.70 per barrel, respectively, in August 2019.

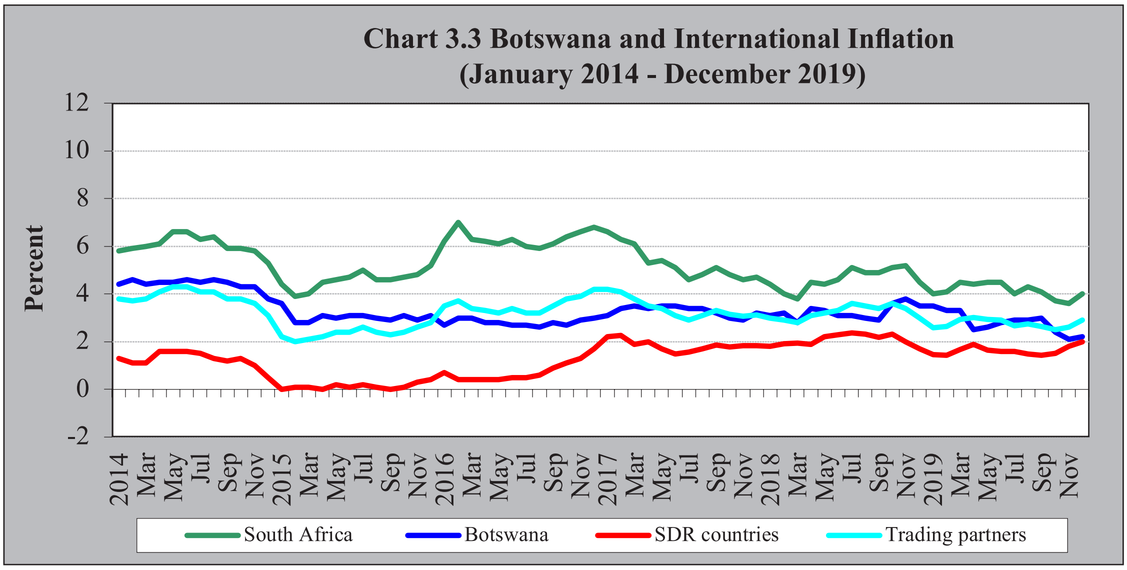


Source: OPEC and US Energy Information Administration.



Source: Food and Agriculture Organisation.

3.5 For Botswana's trading partner countries, trade-weighted average inflation was unchanged at 2.9 percent in December 2018 and December 2019.[11] Inflation was subdued in the SDR countries, increasing slightly from an average of 1.7 percent in December 2018 to 2 percent in December 2019, while in South Africa, inflation remained within the target range of 3 – 6 percent, declining from 4.5 percent in December 2018 to 4 percent in December 2019 (Chart 3.3).



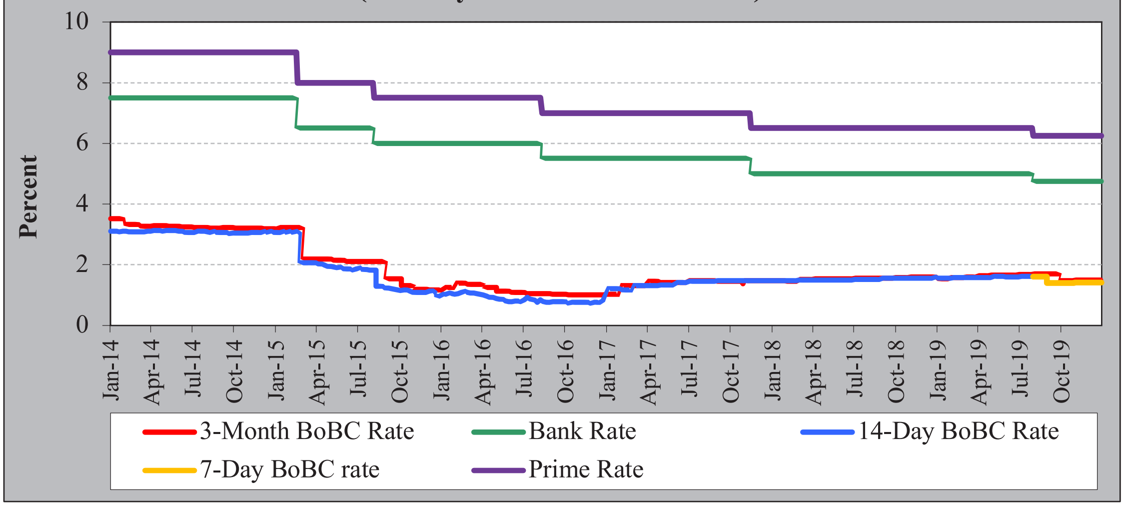
Source: Statistics Botswana and Bloomberg.

11 The trade-weighted average inflation comprises South Africa's headline inflation and average SDR countries' inflation.

(b) Monetary Policy Implementation in Botswana

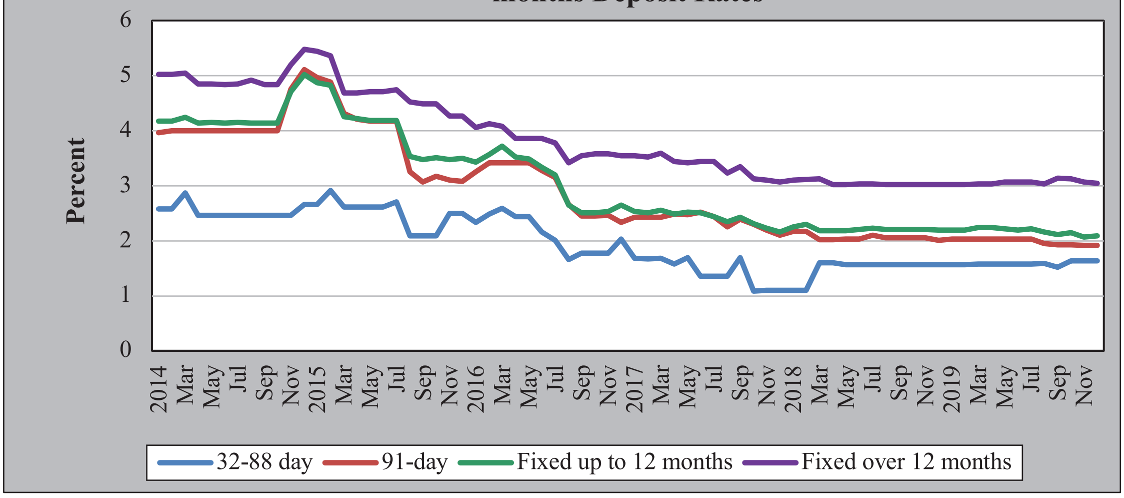
3.6 Monetary policy in Botswana was conducted against the background of below-trend economic activity (a non-inflationary output gap) and a positive medium-term inflation outlook (see Table A2 in Appendix). These conditions provided scope for an accommodative monetary policy stance in support of stronger output growth. Hence, the Bank Rate was reduced by 25 basis points from 5 percent to 4.75 percent in August 2019, the first policy change since October 2017, when the Bank Rate was reduced by 50 basis points to 5 percent. Consequently, the prime lending rate of commercial banks declined from 6.5 percent to 6.25 percent, while deposit interest rates generally increased despite the high levels of market liquidity, mainly reflecting competition for corporate deposits that form an important component of the deposit base for several of the commercial banks (Charts 3.4 and 3.5).

Chart 3.4: Interest Rates (January 2014 - December 2019)



Source: Bank of Botswana and commercial banks.

Chart 3.5: 32-88 day, 91-day, Fixed up to 12 months and Fixed over 12 months Deposit Rates



Source: Commercial banks.

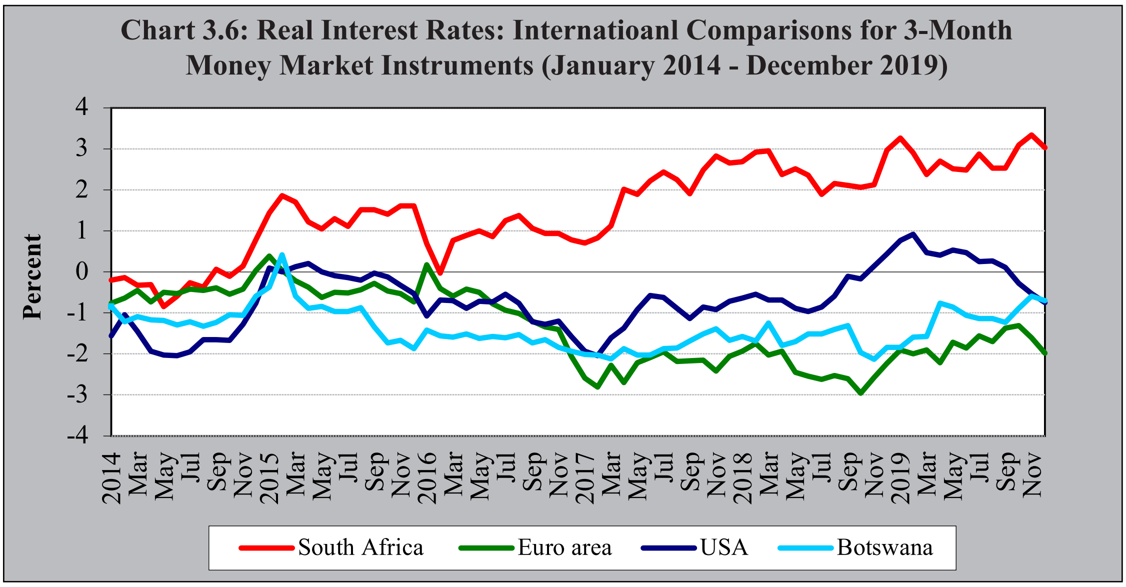
3.7 Monetary policy implementation entailed the use of Bank of Botswana Certificates (BoBCs) to mop-up excess liquidity[12] in order to maintain interest rates that are consistent with the monetary policy stance. The Bank evaluates the monetary policy implementation framework on a regular basis for effectiveness, and introduces refinements where necessary. In that regard, banks continue to make good use of the additional flexibility for effective liquidity management by the extension in 2017 of eligible collateral to include government securities of all maturities for access to the Bank's Credit Facility. In addition, and as announced in the 2019 Monetary Policy Statement, during the course of 2019, the Bank introduced the 7-day BoBC as the main instrument for conducting monetary operations to replace the 14-day paper together with 'reserve averaging' in the determination of the Primary Reserve Requirement (PRR). Both measures, which were introduced on April 30 and October 9, 2019, respectively, were welcomed enthusiastically by the market as expected, providing the basis for improved liquidity management by both the Bank and the commercial banks. In particular, commercial banks are now actively using the Primary Reserve account as a tool for effective management of liquidity (only two of the banks currently do not use it on a regular basis) and the Bank envisages 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. This was in the context of removing the cap of P10 billion on BoBC issuance, allowing the Bank to deal more effectively with any surges in market liquidity. In the circumstances, outstanding BoBCs amounted to P8.6 billion in December 2019, an increase from P8.2 billion in December 2018, reflecting an increase in liquidity that had to be mopped-up in the same period to anchor the monetary policy stance.

3.8 Finally, during 2019, the Bank undertook extensive consultation with local commercial banks and research, including review of practice in other jurisdictions to help guide possible reforms relating to further strengthening of the monetary policy transmission. These include alternatives to the Bank Rate as the 'anchor policy rate' and establishing a more effective interest rate corridor around this rate to support development of the interbank market. Proposals in this regard are expected to be announced shortly.

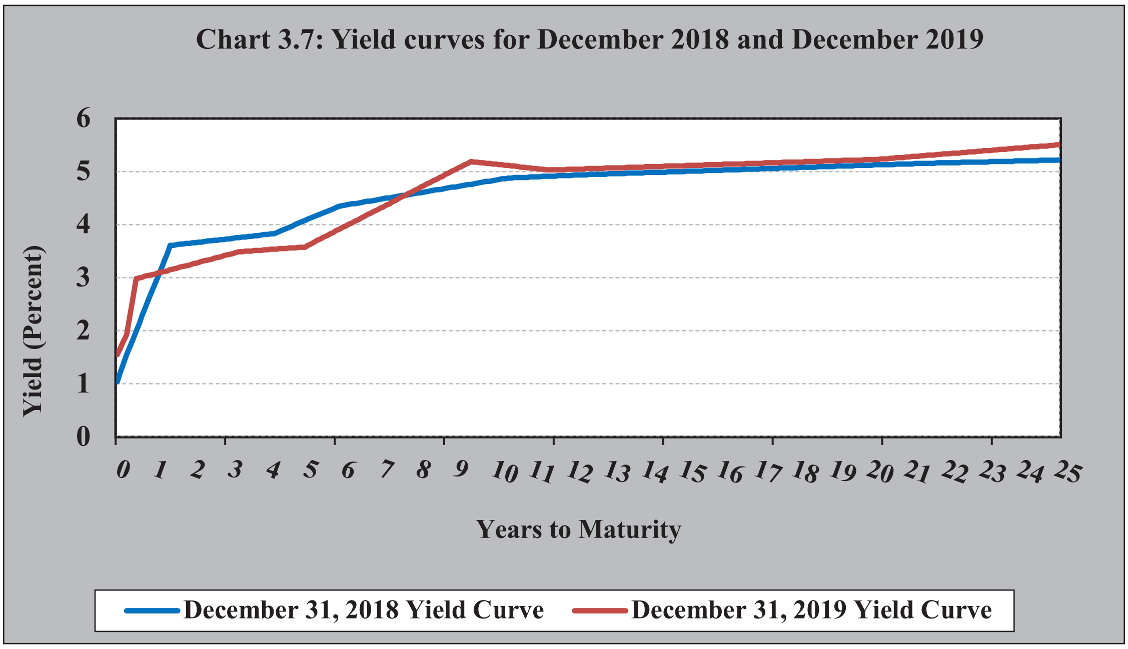
3.9 BoBC yields decreased in 2019, following the reduction of the Bank Rate. Thus, the 91-day BoBC stop-out yield eased from 1.59 percent in December 2018 to 1.49 percent in December 2019. However, due to the larger fall in inflation compared to nominal interest rates between December 2018 and December 2019, the 91-day BoBC real interest rate increased from -1.85 percent in December 2018 to -0.69 percent in the same period (Chart 3.6). Meanwhile, in December 2019, the stop-out yield for the 7-day BoBC was 1.43 percent, lower than the 1.62 percent in May 2019 when it was first introduced. However, the real rate of interest for the 7-day BoBC increased from -0.96 percent to -0.75 percent in the same period.

[12] Excess liquidity is the sum of commercial banks' overnight deposits with the Bank (current account), money absorbed through BoBCs and outstanding reverse repos, less both repos and borrowing from the Bank's credit facility. This is 'excess' in the sense that it is the net liquidity that the central bank has to absorb (take out of the system), over and above the structural liquidity that is held by the banks in the Primary Reserve Requirement accounts.

3.10 Chart 3.7 shows Government bond and BoBC yields as at the end of December 2019 compared to December 2018. Over the review period, yields were generally lower at the shorter end and virtually unchanged in the mid-section of the yield curve, but increased slightly on the longer-end of the curve. The yield increase for longer dated bonds was due to subdued demand as reflected by high yields sought by primary dealers.



Source: Bank of Botswana, South African Reserve Bank and Bloomberg.



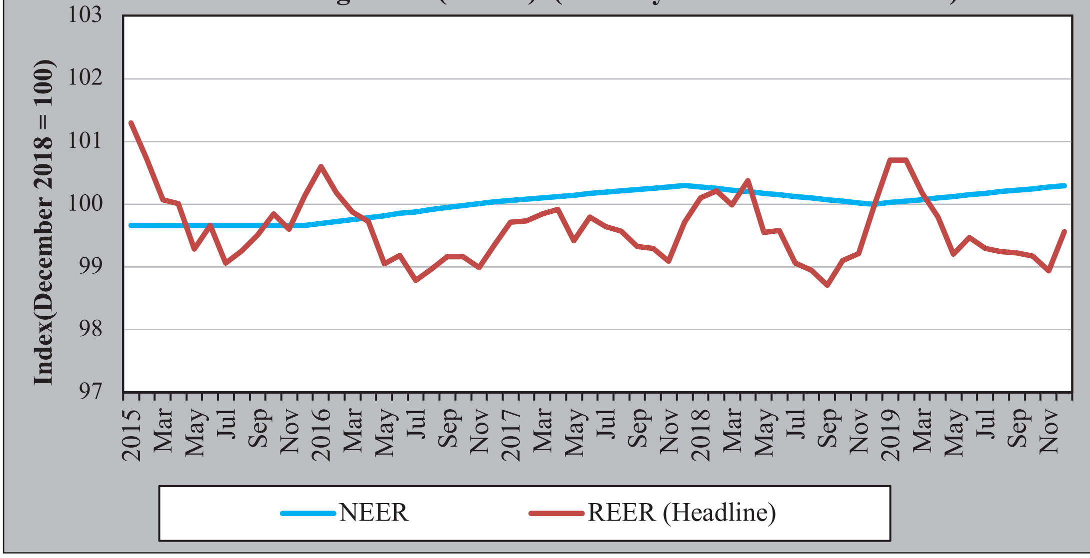
Source: Bank of Botswana.

(c) Implementation of Exchange Rate Policy

3.11 Implementation of the exchange rate policy was in line with the objective of maintaining a stable inflation-adjusted trade-weighted exchange rate of the Pula. This involved implementation of a 0.3 percent upward rate of crawl of the NEER during 2019 as domestic inflation was forecast to be close to the lower end of the medium-term inflation objective range and lower than the expected average inflation for trading partner countries. Consequently, the trade-weighted NEER of the Pula appreciated by 0.3 percent in 2019.

Meanwhile, the REER depreciated by 0.4 percent in the twelve months to December 2019 (Chart 3.8), due to lower inflation in Botswana (2.2 percent) than in trading partner countries (2.9 percent); thus the differential being larger than the upward rate of crawl implemented during 2019.

Chart 3.8: Nominal Effective Exchange Rate (NEER) and Real Effective Exchange Rate (REER) (January 2015 - December 2019)



Source: Bank of Botswana.

(d) Fiscal Policy and Wage Developments

3.12 Monetary policy was conducted within a fiscal policy environment that was supportive of domestic economic activity, with government expenditure expanding by 13.1 percent in the nine months to December 2019 compared to 0.8 percent growth in the corresponding period ending in December 2018. Recurrent and development expenditure increased by 14 percent and 3.4 percent, respectively, in the same period. Meanwhile, the recent quarterly labour force survey results, by Statistics Botswana, for the three months period from July to September 2019, indicate an unemployment rate of 20.7 percent for the third quarter of 2019 (youth unemployment at 26.7 percent) and reinforces the assessment of below potential performance of the economy, modest demand and, consequently, subdued pressure on inflation.

3.13 The quarterly survey also indicates that Government continues to be the single largest employer, with employment in public administration constituting 29 percent of the total. In this regard, personal emoluments constitute the largest share in the government recurrent budget, consistently averaging more than 40 percent and about 10 percent relative to GDP. Personal emoluments increased by 14.4 percent in 2019, following the April 2019 salary increase[13] and this would have been replicated by other major employers. However, the impact on inflation was muted, as it remained subdued in 2019.

(e) Credit and Financial Stability Review

3.14 Vulnerabilities to financial stability remain generally limited and contained, as was reported in the Financial Stability Report published in September 2019. In particular,

[13] Public service employees on salary grades A and B; C and D; and E and F were awarded 10 percent, 6 percent and 4 percent salary increment, respectively.

the domestic financial system continues to be resilient as manifested by the current strong capital buffers and high levels of liquidity, healthy profit levels, and given positive prospects for economic growth and a predictable path for macroeconomic policies. The vulnerabilities relating to potential for excessive and rapid credit growth, liquidity and funding risk, corporate leverage, inflated asset valuations and interlinkages between banks and non-bank financial institutions (NBFIs), were generally contained and posed minimal risk to financial stability.

3.15 Banks maintained good quality assets in 2019, with a decline in credit default rates. The ratio of non-performing loans (NPLs) to total credit was 4.8 percent in December 2019, compared to 5.4 percent in December 2018; the NPL ratio for individual banks ranged from zero to 6.3 percent in December 2019. By sector, the ratio of NPLs to total loans for households decreased from 4.2 percent in December 2018 to 3.2 percent in December 2019, while for businesses, it increased from 7.3 percent to 7.5 percent in the same period. There was, however, sufficient provisioning by banks to cover NPLs, with banks remaining profitable. Overall, the capital, asset quality, liquidity and profitability levels that meet prudential requirements for banks indicate a generally sound and stable financial system (Table 3.2).

Table 3.2: Selected Performance Indicators of the Banking Sector

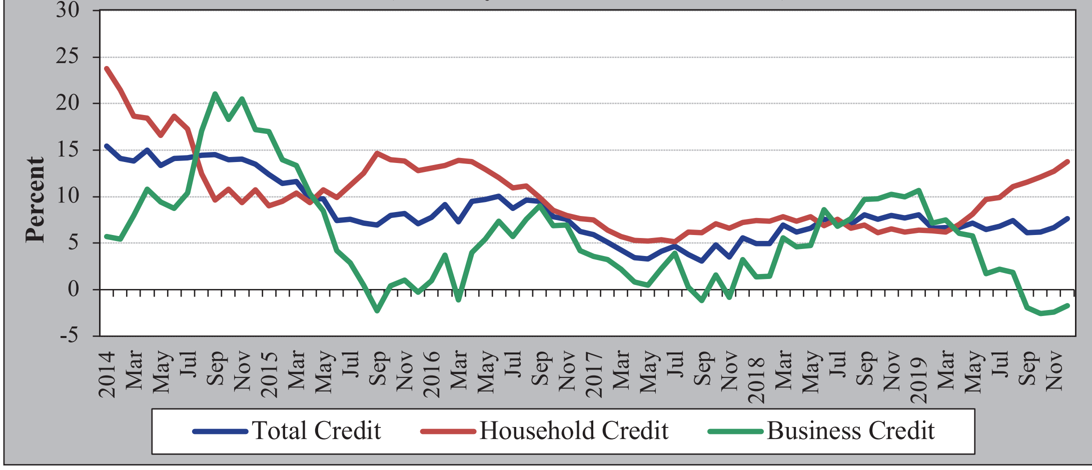
	Dec 2019	Sep 2019	Dec 2018	Sep 2018
Capital Adequacy (Percent)				
Core Capital to Unimpaired Capital[1]	67.9	68.9	68.0	67.2
Tier 1 Capital to Risk-Weighted Assets[2]	13.3	12.8	13.2	12.3
Unimpaired Capital to Risk-Weighted Assets (Capital Adequacy Ratio)[3]	18.4	18.6	17.9	18.2
Asset Quality (Percent)				
NPLs to Gross Loans	4.8	5.2	5.4	5.3
NPLs Net of Specific Provisions to Unimpaired Capital	9.4	12.1	15.0	14.3
Specific Provisions to NPLs	59.0	52.7	42.7	47.6
Liquidity (Percent)				
Liquid Assets to Deposits (Liquidity Ratio)[4]	18.3	18.7	17.8	16.5
Advances to Deposits (Intermediation Ratio)	82.9	81.1	84.2	83.8
Profitability/Efficiency (Percent)				
Return on Average Assets (ROAA)	2.3	1.7	2.8	3.9
Return on Equity (ROE)	19.4	14.3	23.3	33.6
Cost to Income	58.1	58.5	58.5	59.1

Source: Bank of Botswana.

Notes: 1. Prudential lower limit is 50 percent.
2. Prudential lower limit is 7.5 percent.
3. Prudential lower limit is 15 percent.
4. Prudential lower limit is 10 percent.

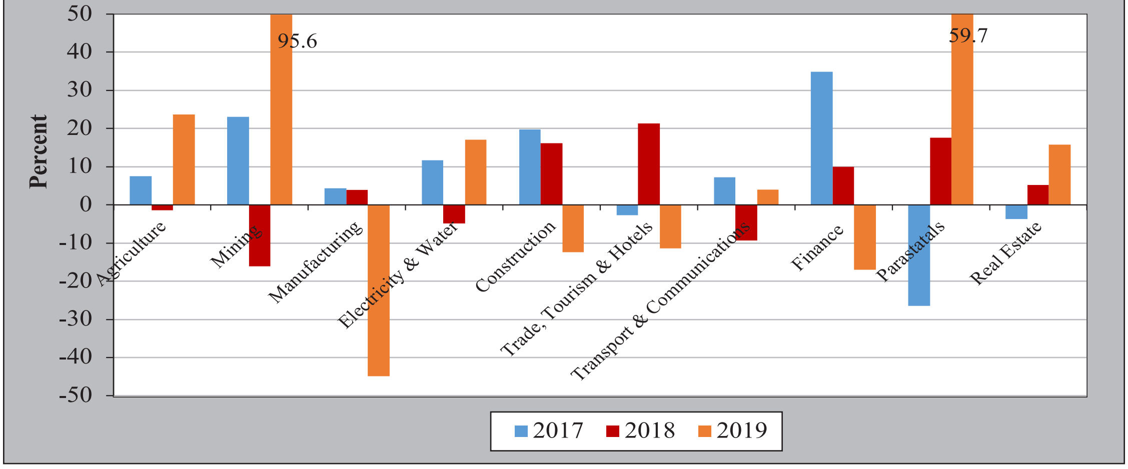
3.16 Annual growth in commercial bank credit decreased from 7.7 percent in December 2018 to 7.6 percent in December 2019 (Chart 3.9). The lower annual credit growth was mostly associated with the decrease in growth of lending to businesses from 10 percent in December 2018 to a contraction of 1.7 percent in December 2019. This was mostly due to loan repayments as well as reduced utilisation of credit facilities by some companies in the manufacturing sector, some of them in the diamond cutting and polishing industry. Although, on aggregate, lending to businesses excluding parastatals contracted by 5 percent in 2019, a variety of different economic sectors benefited from the extension of bank credit (Chart 3.10).

Chart 3.9: Commercial Bank Credit Annual Growth Rates (January 2014 - December 2019)

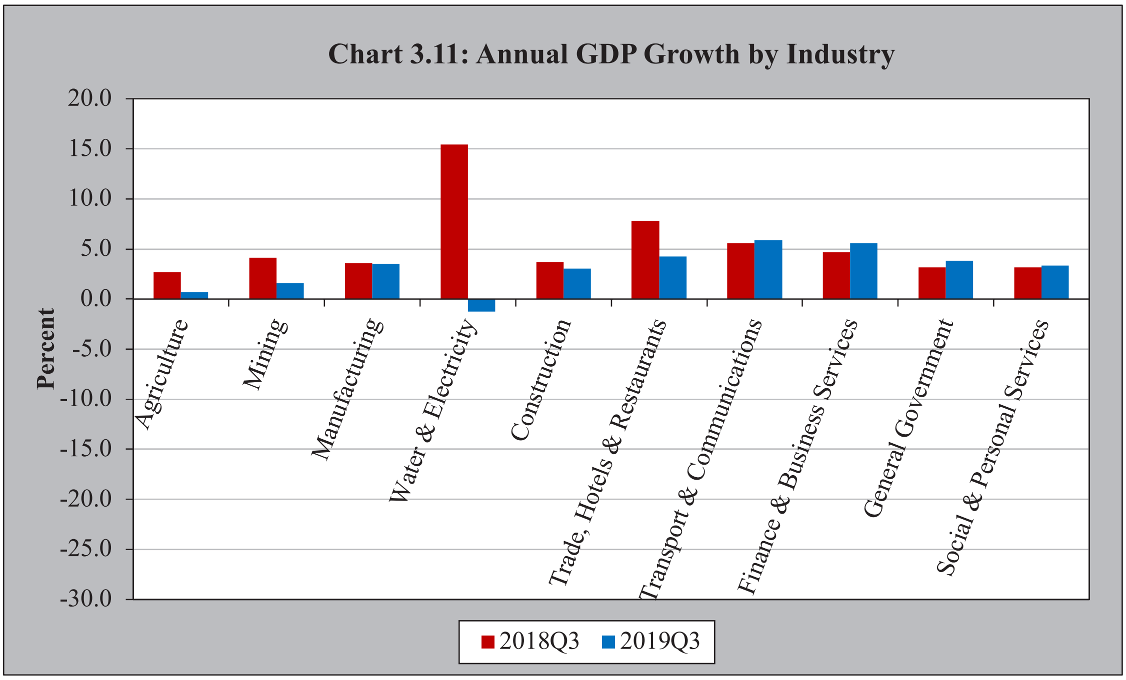


Source: Commercial banks.

Chart 3.10: Annual Growth of Commercial Bank Business Credit by Industry



Source: Commercial banks.



Source: Statistics Botswana and Bank of Botswana calculations.
Note: The growth rate is calculated as the percentage change in cumulative GDP over four quarters compared to the corresponding period in the previous year.

3.17 For households, annual credit growth increased from 6.2 percent in December 2018 to 13.8 percent in December 2019. The higher rate of increase in lending to households was mostly due to the acceleration in the annual rate of expansion in personal loans, which increased from 7 percent in December 2018 to 18.7 percent in December 2019. The faster increase in personal loans is consistent with higher demand (through scheme loan arrangements), availability of loanable funds at banks as well as the increase in public service salaries earlier in the year. Meanwhile, the annual growth for all the unsecured loans[14] increased from 6.8 percent to 18.3 percent in the same period. In contrast, the annual increase in mortgage loans fell from 4.9 percent to 3 percent in the same period. Consequently, the share of mortgages in total bank credit to households decreased from 27.4 percent in December 2018 to 24.8 percent in December 2019.

3.18 In general, the level of credit and rate of increase continue to be supportive of economic activity. Notably, the credit to GDP ratio increased (Table 3.3), indicating the steadily growing importance of credit in supporting economic activity, albeit remaining comparatively low by global standards (Appendix Table A1).

14 Unsecured loans include personal loans and credit card loans.

Table 3.3: Commercial Bank Credit-to-GDP Ratio

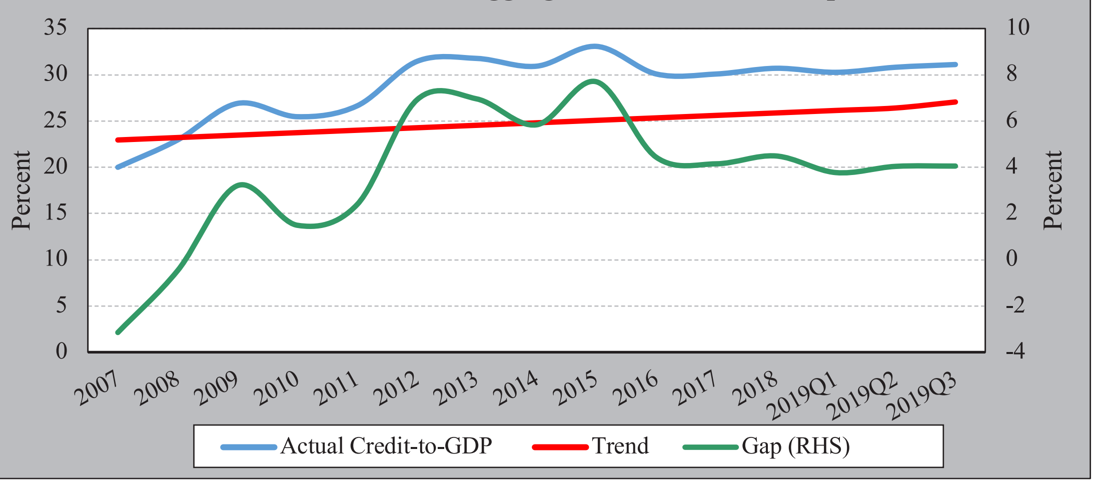
	Percent of GDP		
	2017	**2018**	**2019[2]**
Total Commercial Bank Credit	**30.1**	**30.6**	**31.1**
Business[1]	**11.7**	**12.2**	**11.5**
Parastatals	0.5	0.6	0.7
Agriculture	0.7	0.6	0.8
Mining	0.2	0.2	0.3
Manufacturing	1.9	1.9	1.3
Construction	0.6	0.6	0.6
Trade	2.3	2.7	2.3
Transport and Communications	0.4	0.3	0.3
Finance and Business Services	2.4	2.6	2.3
Real Estate	2.0	2.0	2.2
Households	**18.4**	**18.5**	**19.6**
Retail Credit[3]	13.1	13.4	14.6
Mortgage	5.1	5.1	5.0

Source: Commercial banks, Statistics Botswana and Bank of Botswana calculations.

Notes:
1. Although not shown in the table, electricity and water, other and non-resident sub-sectors are included in the business credit to GDP ratio.
2. Data covering the twelve months to September 2019.
3. Includes motor vehicle, personal and credit card loans.

3.19 Commercial bank credit growth is moderate, and commensurate with the rate of increase in GDP, as measured by the credit-to-GDP gap, which was below both its trend and the 10 percent threshold at the end of September 2019 (Chart 3.12). The low credit-to-GDP gap signifies that there is room for sustained economic expansion from positive shocks to financial conditions. Furthermore, the gap has been positive since the global financial crisis, mainly reflecting the trend decline in the rate of GDP growth, which in the main, was due to the overall subdued performance of the mining sector. A credit-to-GDP gap that moves significantly above its trend or exceeds some critical threshold (typically 10 percent) portends emerging financial imbalances and risk of financial distress.

Chart 3.12: Aggregate Credit to GDP Gap

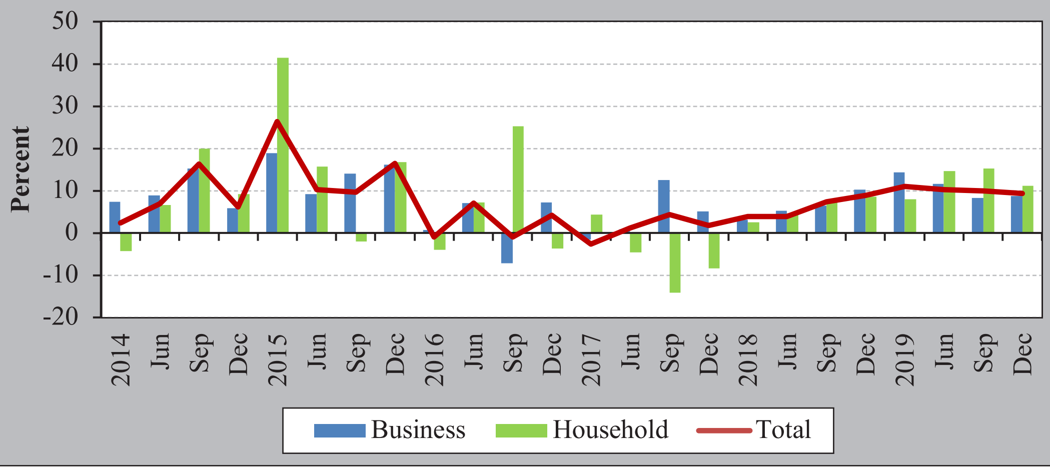


Source: Bank of Botswana.

3.20 Household loans continue to dominate commercial bank credit, with a share of 63.7 percent of total loans in December 2019, higher than 60.2 percent in December 2018. Furthermore, household credit is concentrated in unsecured lending (70.1 percent as at December 2019). However, developments with respect to household credit are consistent with the increase in wages in 2019, in particular the faster growth in salary-backed personal loans; thus limited risk to financial stability. On the other hand, the reduction in mortgage credit growth in the context of the weaker property market and responsive risk management by banks moderates potential risks in this area.[15] Overall, the risk to financial stability, on account of this credit composition, is moderated by the fact that the bulk of the household credit is to salaried individuals, which enables proper credit evaluation using ascertained income as the basis for determining repayment capacity.[16] In addition, credit risk is lowered where loans are protected by credit life insurance, though this could mean credit risk transfer to the insurance sector.

3.21 A persistent challenge remains the concentration of private business deposits in commercial banks' funding structure (69.1 percent of total deposits in December 2019), reflecting an imbalance in the market and the potential increase in the cost of their liabilities. Notably, there was a significant increase in household deposits by 11.1 percent in December 2019 compared to 8.6 percent growth in 2018. This could reflect potential alleviation of financial strain on households arising from the growth in incomes during the year. On the other hand, business deposits (excluding parastatals) increased by 7.1 percent in December 2019, down from 8.7 percent in 2018. Overall, deposits at commercial banks increased by 9.3 percent in December 2019, adding to the 8.9 percent increase in 2018 (Chart 3.13). Given the higher increase in bank deposits than the growth in bank lending, the financial intermediation ratio declined from 84.2 percent in December 2018 to 82.9 percent in December 2019.

Chart 3.13: Annual Growth in Business and Household Deposits at Commercial Banks



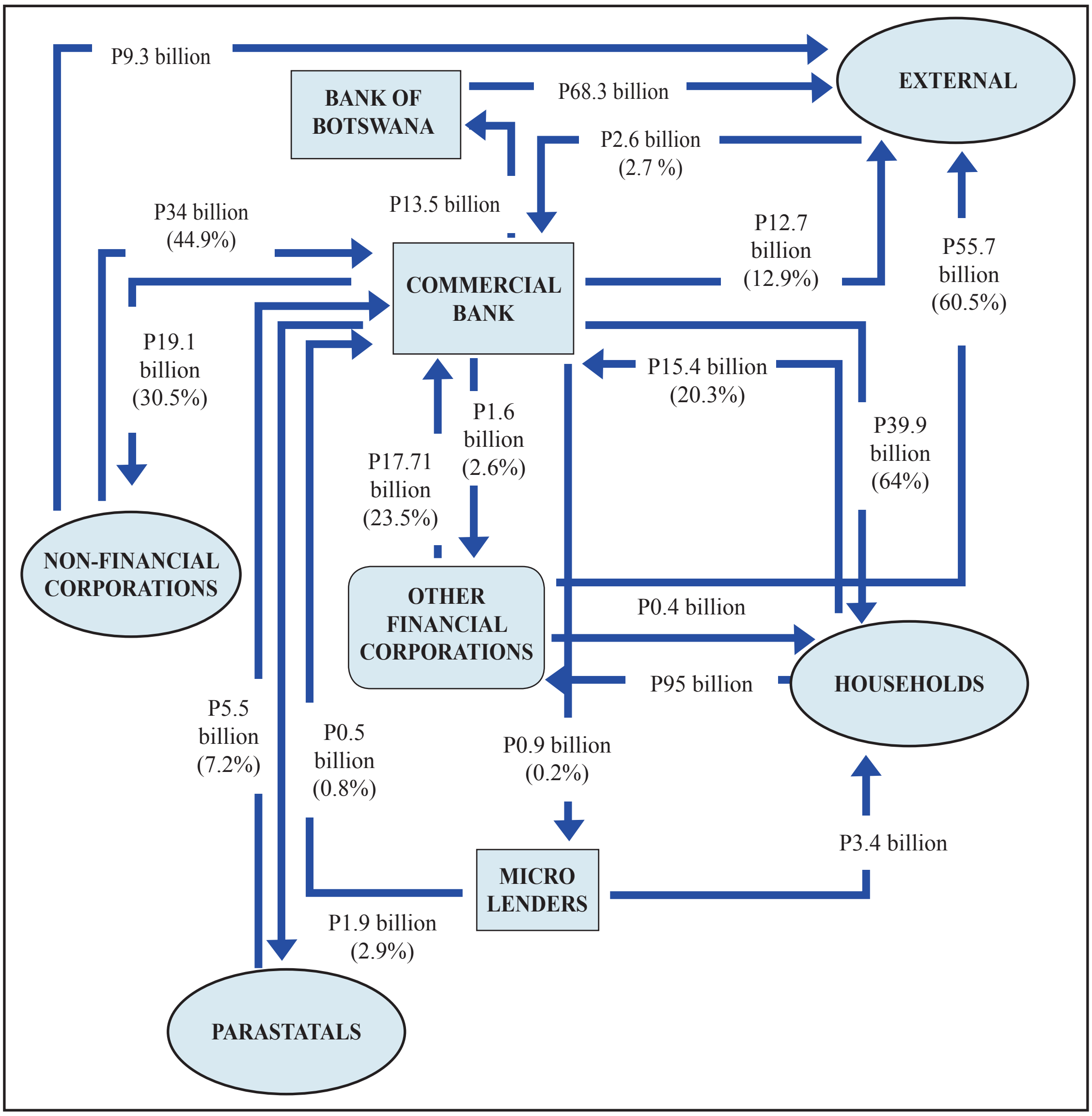
Source: Commercial banks.

15 Even then, the need for creating a conducive environment, including deliberate commercial bank strategies, for raising the importance of mortgage financing in the economy is acknowledged.

16 There is, nevertheless, some risk relating to borrowing by individuals from multiple institutions and sources, which could lead to excessive debt burdens.

3.22 A broad perspective of the formal financial sector (short and long-term savings, including pension funds) shows that households are net savers, a position that has progressively increased since the establishment of the Botswana Public Officers Pension Fund in 2001. In the circumstances, the linkages between banks, non-bank financial institutions and household savings are intricate and symbiotic and require comprehensive oversight, involving monitoring of soundness of the relevant financial institutions, safeguarding of depositor-investor funds and protecting the integrity of the financial system (Figure 3.1). Therefore, the Bank and the Non-Bank Financial Institutions Regulatory Authority (NBFIRA) provide the regulatory framework, supervisory oversight and enforcement mechanisms that promote sound and productive mobilisation and deployment of financial resources; preservation of value and risk mitigation; proper discharge of fiduciary responsibilities; market discipline; as well as penalise misconduct and enforce remedial measures, as necessary.

Figure 3.1: Structure of the Financial System (December 2019)



Source: Bank of Botswana; estimates based on data provided by financial institutions regulated by Bank of Botswana and Non-Bank Financial Institutions Regulatory Authority.

Note: The percentages indicate shares of loans/deposits for the sector.

3.23 The regulatory framework also encompasses structures for collaboration among the relevant authorities to achieve comprehensive monitoring and enforcement of legislation and regulations in order to maintain integrity and stability of the financial system. In this regard, the Financial Stability Council, comprising the Ministry of Finance and Economic Development, Bank of Botswana, Non-Bank Financial Institutions Regulatory Authority and the Financial Intelligence Agency, was officially launched in February 2019. The Council, whose primary mandate is to coordinate macroprudential policy, analysis and response to threats to financial stability, oversaw the publication of the maiden Financial Stability Report (FSR)[17] and adopted a macroprudential policy framework for Botswana. The objective of the policy is to assess financial vulnerabilities, monitor and limit systemic risks and transmission to the broader economy. The Council also approved the process towards establishment of a deposit protection fund (DPF).[18] Consultations with relevant stakeholders on the proposal commenced in December 2019, and are expected to be concluded in 2020.

3.24 Furthermore, the Bank continues to work alongside other national authorities to respond adequately to the adverse evaluation relating to the effectiveness of the national anti-money laundering and combating the financing of terrorism arrangements. The latest assessment of Botswana's progress towards addressing its strategic Anti-Money Laundering and Combating Financing of Terrorism (AML/CFT) deficiencies was held in January 2020. The Financial Action Task Force - International Cooperation Review Group (ICRG - FATF) Africa/Middle East Joint Group indicated that further progress needed to be made to address outstanding items, including completing the risk assessment on legal persons, legal arrangements and non-profit organisations (NPOs) and applying a risk-based approach to monitoring NPOs and fully implementing risk-based AML/CFT supervisory manuals for bureaux de change, money and value transfer services and designated non-financial businesses and professions, among others. The country will, therefore, remain under monitoring until December 2020. A prolonged stay on the watch list is prejudicial to economic activity as it could adversely affect the conduct of international transactions, thus affecting trade, financial flows and external asset holdings/investments.

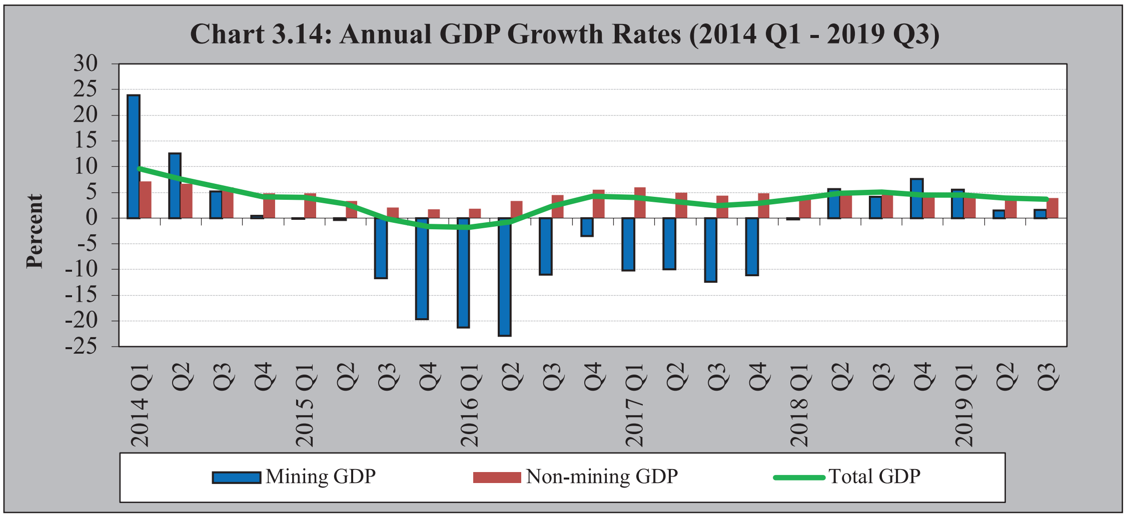
(f) Output and Price Developments

3.25 Real GDP in Botswana grew by 3.7 percent in the twelve months to September 2019, compared to a faster expansion of 5 percent in the year to September 2018 (Chart 3.14). The lower increase in output is mainly attributable to a significant deceleration in output growth of the mining sector. Mining output grew by 1.6 percent in the year to September 2019, compared to an increase of 4.1 percent in the corresponding period in 2018 as diamond output increased at a slower rate of 2.1 percent compared to 3.2 percent in the

17 The FSR was published in September 2019, and provided an assessment of the vulnerabilities to the stability and resilience of Botswana's financial system.

18 The purpose of the DPF is to provide insurance for small depositors, particularly to safeguard the savings and liquidity of average households, in the event of a bank failure, by providing a mechanism for immediate pay out or transfer of the insured portion of their deposits. The DPF could also contribute to financial stability through the avoidance of deposit runs and providing a mechanism for weak banks to be dealt with in a non-disruptive manner.

previous year. Non-mining GDP grew by 4 percent in the year to September 2019 from 5.1 percent in the corresponding period in 2018. The lower growth in non-mining GDP was largely due to slower expansion in the trade, hotels and restaurants sector, mainly attributable to a contraction of 9.2 percent in the wholesale sub-sector, associated with weaker performance of the diamond cutting and polishing firms. The overall growth of the non-mining sector was supported by transport and communications (5.9 percent) and finance and business services (5.6 percent) sectors. Meanwhile, GDP growth was 3.1 percent in the third quarter of 2019, lower than the output growth of 4.1 percent recorded in the corresponding period in 2018.[19]

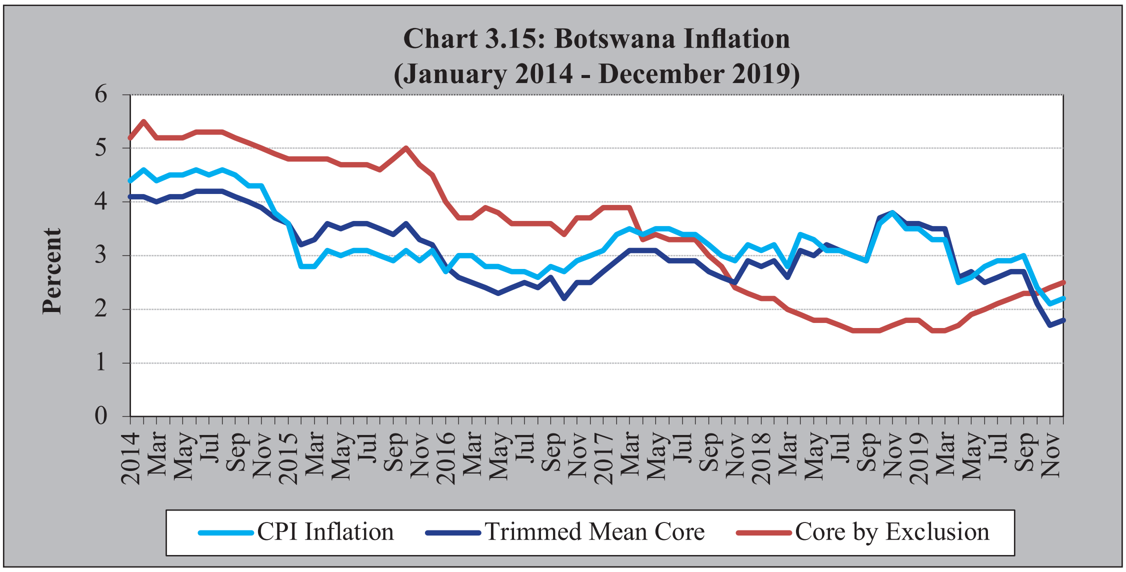


Source: Statistics Botswana and Bank of Botswana calculations.

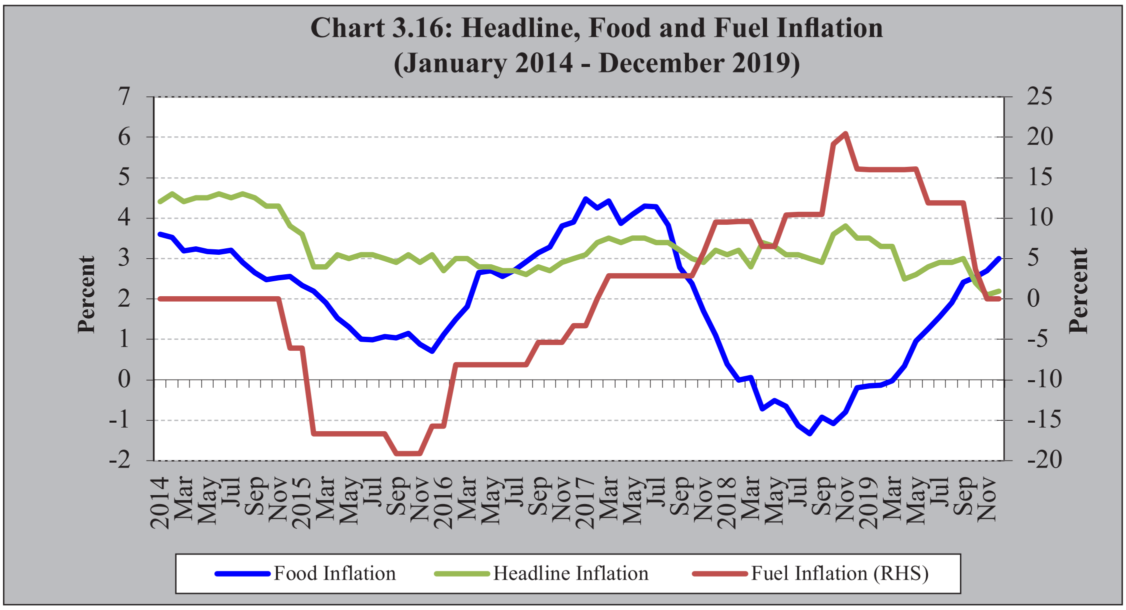
3.26 Inflation was below the lower bound of the Bank's inflation objective range of 3 – 6 percent for most of 2019, against the background of modest domestic demand, the relative strength of the Pula against the South African rand (therefore, lower import prices), and a limited range of increase in administered prices, as well as moderate foreign inflation.

3.27 Inflation decreased from an average of 3.2 percent in 2018 to 2.8 percent in 2019, breaching the lower bound of the Bank's 3 – 6 percent objective range for most of the year (Chart 3.15). Inflation was lower, mainly because the increase in administered prices, in particular, fuel prices, public transport fares and electricity tariffs effected in 2018 was not repeated in 2019. Inflation decreased from 3.5 percent in December 2018 to 2.2 percent in December 2019. Meanwhile, food price inflation increased from -0.4 percent in December 2018 to 3 percent in December 2019 (Chart 3.16), as a result of significant price increases for meat, fish and cereals. Regarding core inflation measures, the 16 percent trimmed mean inflation decreased from 3.6 percent in December 2018 to 1.8 percent in December 2019, while inflation excluding administered prices increased from 1.8 percent to 2.5 percent in the same period.

[19] The 3.1 percent annual growth reported in the Statistics Botswana (SB)'s economic briefing release is calculated on the basis of quarterly output compared to the corresponding period the previous year. Thus, SB reports year-on-year growth based on quarterly GDP.



Source: Statistics Botswana.



Source: Statistics Botswana.

4. OUTPUT AND INFLATION OUTLOOK

(a) Global Economic Prospects

4.1 According to the January 2020 WEO Update, global output growth is forecast at 3.3 percent in 2020, from an estimated expansion of 2.9 percent in 2019. Growth in emerging market and developing economies is projected at 4.4 percent for 2020, higher than the 3.7 percent estimate for 2019. The higher projection is mainly premised on anticipated recovery from severely stressed and underperforming emerging market economies. In India, growth is expected to pick up from 4.8 percent in 2019 to 5.8 percent in 2020, supported by monetary and fiscal stimulus, as well as subdued oil prices.

4.2 Growth in advanced economies is expected to ease to 1.6 percent in 2020 from 1.7 percent in 2019, mostly because of subdued economic performance in the US, projected to moderate to 2 percent in 2020, from 2.3 percent in 2019. The moderation in the

US is attributed to a return to a neutral fiscal stance, anticipated waning support from further loosening of financial conditions and restrictive trade policy. Meanwhile, the UK economy is forecast to grow by 1.4 percent in 2020, from 1.3 percent in 2019, in the context of an orderly exit from the EU and a gradual transition to the new arrangement. Overall, risks to global economic activity are skewed to the downside. The main risks include possible escalation in geopolitical tensions, notably between the US and Iran, intensification of social unrest, further worsening of relations between the US and its trading partners, and deepening economic frictions between other countries. Moreover, there are mounting concerns of a global growth slowdown due to the spread of the coronavirus.[20]

4.3 Global inflationary pressures are forecast to be modest in the short to medium term, reflecting below potential output. There is, however, downward pressure on inflation emanating from the decrease in commodity prices, particularly oil. In 2020, inflation is forecast at 1.9 percent in advanced economies and 4 percent in emerging market and developing economies, contributing to projected global inflation of 3.1 percent. Given modest inflation and below-potential output, it is anticipated that monetary policy will remain accommodative in most economies, complemented by measures aimed at facilitating financial intermediation and fostering the resilience of the financial sector, to support economic activity.

4.4 Inflation is forecast at 1.7 percent and 4.7 percent in the SDR countries and South Africa, respectively, in 2020. Therefore, average inflation for trading partner countries is forecast to be in the range of 3 – 4 percent. Since the projected inflation is around the lower end of the Bank's inflation objective range in 2020, amidst sluggish economic activity, the economy could benefit from a depreciation of the Pula against trading partners in order to boost exports and promote diversification, while there is no upside inflationary threat to the objective. The Pula basket weights have been maintained at 45 percent for the South African rand and 55 percent for the SDR. Against this background, an annual downward rate of crawl of 1.51 percent of the NEER, based on the mid-point of the objective range is being implemented effective January 2020.

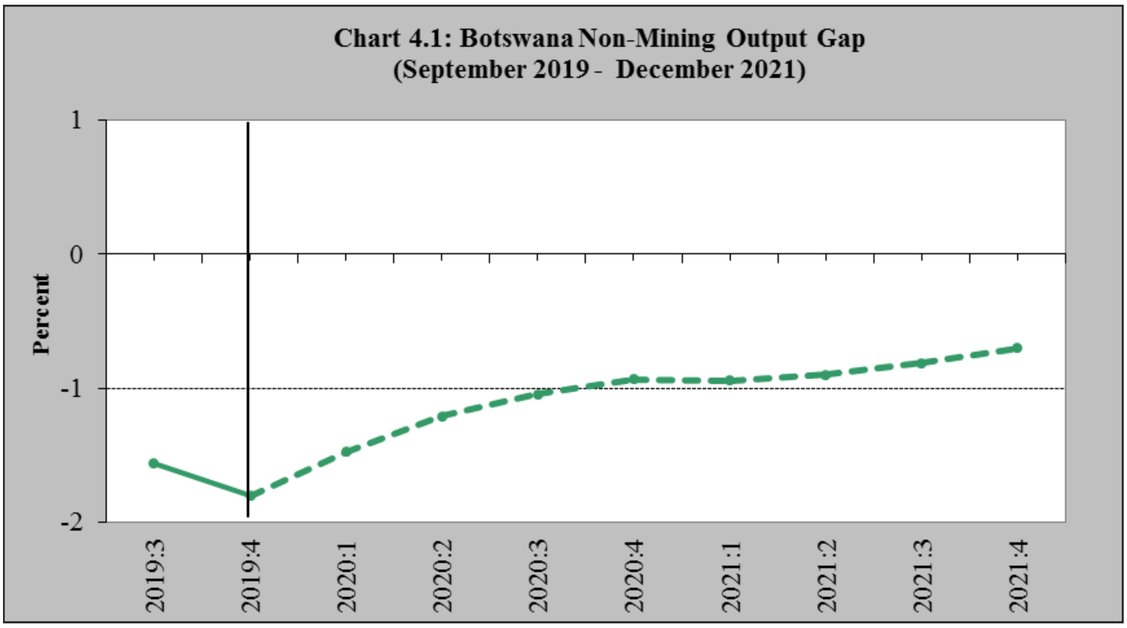
(b) Domestic Economic Prospects

4.5 Domestically, real GDP is projected to expand by 4.4 percent in 2020, driven mainly by the expected recovery of mining activity and anticipated improvement in global output. The non-mining sectors are also anticipated to improve, underpinned by, among others, the accommodative monetary conditions in the domestic economy, improvements in electricity and water supply, as well as the reforms to further improve the business environment. Non-mining GDP is expected to increase by 4.5 percent in 2020, thus below trend (Chart 4.1) and weighed down mainly by the modest expansion of economic activity in major trading partners. However, risks to global economic activity are skewed to the downside and could result in a fall in global demand and commodity prices, especially for rough diamonds, dampening the domestic economic outlook.

20 On December 31, 2019, a new type of coronavirus, officially named Covid-19 by the World Health Organisation (WHO), was reported in Wuhan City, Hubei Province of China. The virus has since spread, with WHO declaring it as a public health emergency of international concern.

Nonetheless, the Bank's December 2019 Business Expectations Survey (BES) indicates an improvement in the level of confidence among businesses in 2020.

4.6 To finance the budget deficit (as announced in the 2020 Budget Speech), Government intends to borrow both domestically and externally. Domestic borrowing will entail issuance of Government debt securities such as treasury bills and long-term Government bonds, while external borrowing will be restricted to concessional borrowing from both bilateral and multilateral development partners. Government will also consider additional measures to increase domestic revenue sources by being more effective in tax collection (mainly value added tax), as well as through an upward adjustment of some user fees, which had not been raised for many years. These developments may augment public revenue which could enable government to increase expenditure in areas such as infrastructure and, thus, attract investment that can contribute to economic growth.

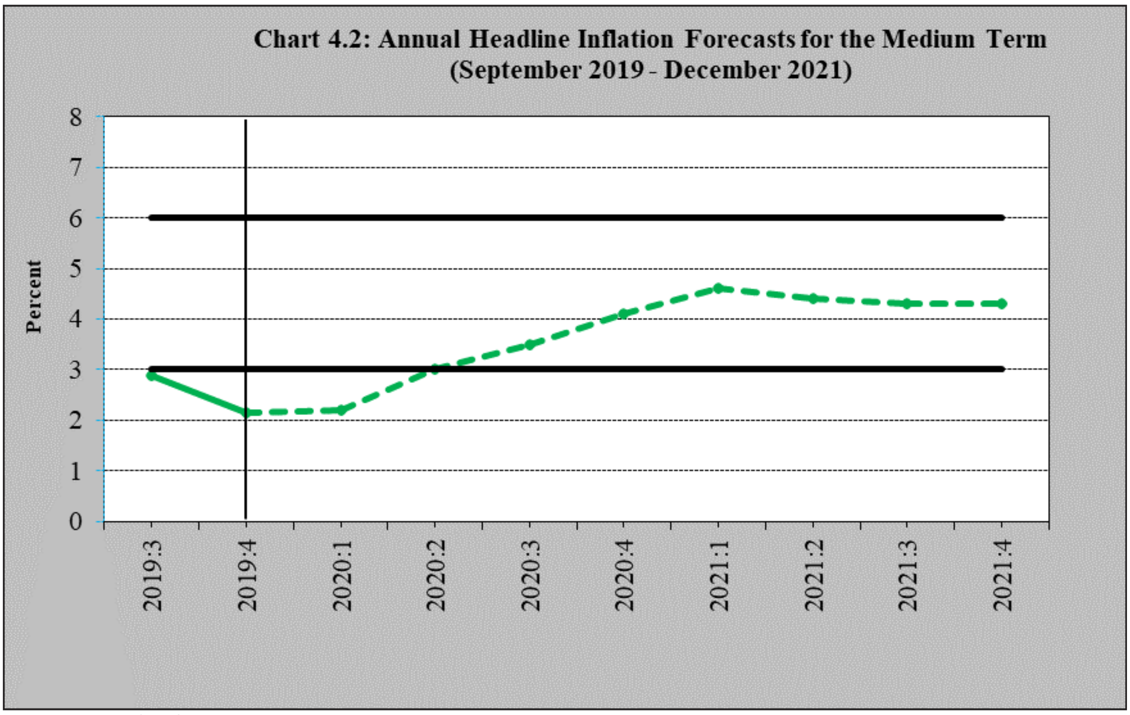


Source: Bank of Botswana.

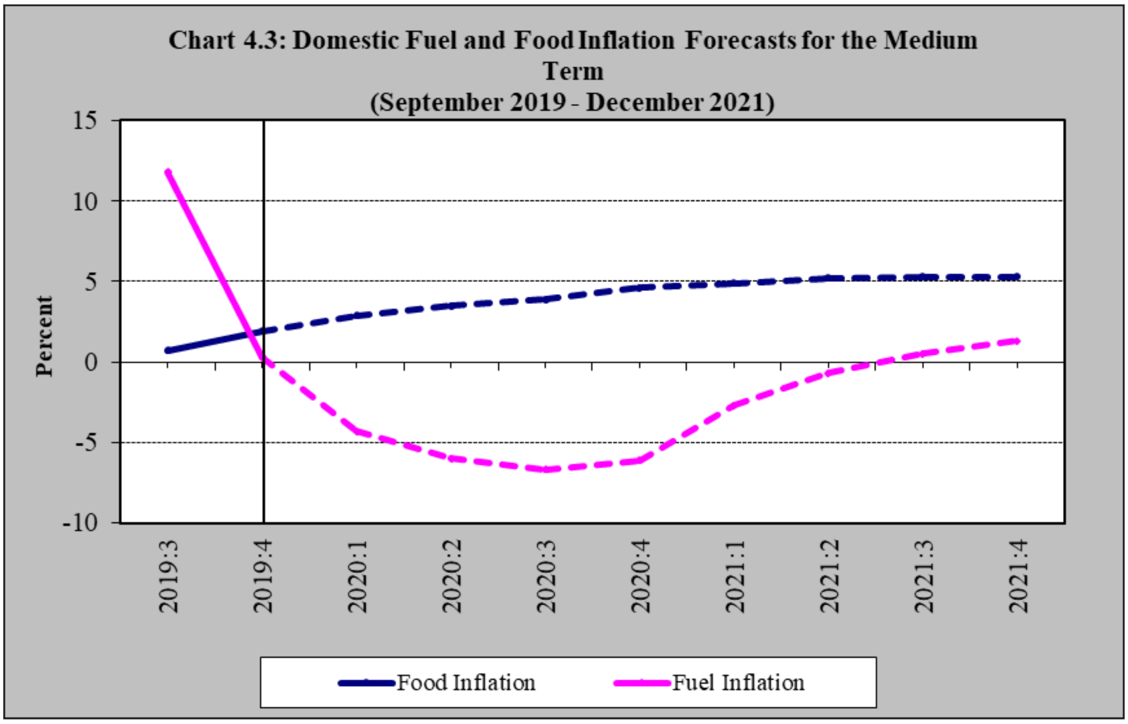
4.7 Headline inflation is forecast to revert to within the Bank's 3 – 6 percent medium-term objective range from the second quarter of 2020 (Chart 4.2). The projection takes into account the possibility of an increase in electricity and water tariffs in the second quarter of 2020, as well as the previously announced increase in public service salaries[21] in the 2020/21 financial year. The projection also incorporates the effect of the 1.51 percent downward rate of crawl that is being implemented for the year 2020, which should potentially see inflation gravitating towards 4.5 percent in the medium term. Meanwhile, the expected increase in government spending (10.1 percent) for 2019/20 financial year and the 13.8 percent increase in credit to households in 2019 are not expected to have any significant influence on domestic demand, hence inflation because of possible leakages in the form of payments for imports. Upside risks to the inflation outlook relate to any unanticipated substantial upward adjustment in administered prices and government levies and/or taxes, as well as the potential increase in international commodity prices beyond current forecasts. These risks are moderated by continuing subdued global

[21] Public service employees on salary grades A and B; C and D; and E and F to be awarded 10 percent, 6 percent and 4 percent salary increment, respectively.

economic activity, the tendency of technological progress to lower costs and prices (or dampen the rate of increase) and the potential fall in international commodity prices. Domestically, the continuance of modest economic growth contributes to moderate domestic inflation. Meanwhile, according to the December 2019 BES, the business community expect inflation to be within the Bank's objective range in 2020, suggesting that inflation expectations are well-anchored.



Source: Bank of Botswana.



Source: Bank of Botswana.

5. 2020 MONETARY POLICY STANCE

5.1 An evaluation of the determinants of inflation and factors affecting financial stability suggests maintenance of a continuation of low and predictable level of inflation into the medium term, and stable financial system. The modest domestic demand pressures and the restrained increase in foreign prices contribute to the positive inflation outlook in the medium term. The current state of the economy and the outlook for both domestic and external economic activity suggest that the prevailing accomodative monetary policy stance is consistent with inflation being within the objective range of 3 – 6 percent in the medium term. Since inflation is projected to be around the lower end of the Bank's inflation objective range in 2020, amidst sluggish economic activity, the economy could benefit from a measured depreciation of the Pula against trading partners in order to boost exports and promote diversification; while there is no upside inflationary threat to the objective, hence the implementation of the 1.51 percent downward rate of crawl. Furthermore, the current levels of growth in credit to both businesses and households are considered sustainable. Thus, the recent and prospective developments (positive inflation outlook and a stable financial environment) augur well for maintaining an accommodative monetary policy stance that supports productive lending to businesses and households. The Bank will continue to respond appropriately to changes in banking system liquidity conditions through relevant instruments. Overall, the Bank encourages prudent management, investment and productive allocation of financial resources, with a view to promoting growth-supporting intermediation and durable financial stability. In this regard, for effective policy transmission, the Bank guides the determination of the level and direction of market interest rates that are consistent with the monetary policy stance. The Bank also promotes the effectiveness of the interbank market to address liquidity positions of individual banks. In addition, the Bank contributes to financial stability through prudential supervision of commercial and statutory banks and promotes, as well as participates in, coordinated regulation of the broader financial system.

5.2 In 2020, the Bank will continue to implement the crawling band exchange rate policy to stabilise the REER. The crawling band exchange rate policy supports international competitiveness of domestic industries and contributes towards macroeconomic stability and economic diversification. Notionally, relatively high interest rates in South Africa and appreciation of the rand would induce related capital outflows. However, short-term capital movements are constrained by the paucity of listed securities (bonds and equities), and relative illiquidity of financial instruments in the Botswana market, as well as uncertainty associated with a volatile rand exchange rate and higher South African inflation. Moreover, on its own, Botswana represents a stable macroeconomic environment with developmental and business opportunities for inward investment by expanding regional entities.

6. CONCLUSION

6.1 Domestic inflation was mostly below the lower end of the Bank's objective range of 3 – 6 percent in 2019, against the background of base effects associated with the upward adjustment in administered prices in 2018, as well as modest increase in foreign prices. Meanwhile, global inflation is forecast to decline due to slower global output growth.

6.2 It is projected that inflation in Botswana will remain low, stable and within the Bank's medium-term objective range. The Bank's formulation and implementation of monetary policy will focus on entrenching expectations of low and sustainable inflation, through timely response to price developments, while ensuring that credit and other market developments are in line with durable stability of the financial system. The Bank remains committed to monitoring economic and financial developments with a view to ensuring price and financial stability, without undermining sustainable economic growth.

6.3 Broadly, the Bank contributes to macroeconomic stability and policy congruence through the pursuit and attainment of its primary objectives and coordination with relevant institutions with respect to price and financial stability, as well as stability of the inflation-adjusted trade-weighted exchange rate. Through focusing and delivering on its specific roles, the Bank contributes to maintenance of a conducive environment for structural reforms and transformation initiatives to gain traction, potentially leading to higher rates of growth needed to transit the economy to high income status. Given that both monetary policy and fiscal policy are expansionary, immediate implementation of transformation initiatives and structural reforms would raise prospects for faster growth and economic diversification.

Appendix

Table A1: Credit to Private Sector by Banks (Percent of GDP)

	2016	**2017**	**2018**
United States of America	52.4	52.5	52.1
United Kingdom	131.9	133.6	134.5
India	49.2	48.8	50.0
China	157.6	157.0	161.1
Singapore	124.1	122.7	121.9
Chile	79.7	78.4	81.3
Rwanda	20.8	20.7	21.5
Mauritius	96.2	102.3	78.0
Namibia	51.5	49.8	50.0
Kenya	33.4	29.4	27.9
South Africa	66.6	65.6	65.7
Botswana	**31.5**	**31.4**	**31.7**

Source: World Bank's World Development Indicators.

Notes:
1. Domestic credit to the private sector by banks refers to financial resources provided to the private sector by other depository corporations (deposit taking corporations except central banks), such as through loans, purchases of non-equity securities, and trade credits and other accounts receivable, that establish a claim for repayment. For some countries, these claims include credit to public enterprises.
2. Data for 2019 is not available.

Table A2: 2019 Monetary Policy Decisions

MPC MEETING DATES	MPC DECISION	REASON
February 26	Bank Rate maintained at 5 percent	Favourable inflation outlook associated with subdued domestic demand pressures and the modest increase in foreign prices
April 24	Bank Rate maintained at 5 percent	Favourable medium-term inflation outlook associated with moderate domestic demand resulting from the restrained increase in personal incomes and expected modest increase in foreign prices
June 27	Bank Rate maintained at 5 percent	Positive medium-term inflation outlook, supported by subdued domestic demand pressures and the modest increase in foreign prices
August 29	Bank Rate reduced by 25 basis points from 5 percent to 4.75 percent	The state of the economy and the outlook for both domestic and external economic activity provided scope for easing monetary policy to support economic activity
October 31	Bank Rate maintained at 4.75 percent	Favourable medium-term inflation outlook, associated with moderate demand resulting from the restrained increase in personal incomes and expected modest increase in foreign prices
December 5	Bank Rate maintained at 4.75 percent	Positive medium-term inflation outlook, arising from the subdued domestic demand pressures and the modest increase in foreign prices

MONETARY POLICY COMMITTEE MEETING DATES FOR 2020

Date		Time	Venue
February	26	0830 hours	Bank of Botswana
April	30	0830 hours	Bank of Botswana
June	18	0830 hours	Bank of Botswana
August	20	0830 hours	Bank of Botswana
October	8	0830 hours	Bank of Botswana
December	3	0830 hours	Bank of Botswana