MID-TERM REVIEW OF THE
2012 MONETARY POLICY STATEMENT

1. Introduction

1.1 The Mid-Term Review (MTR) of the 2012 Monetary Policy Statement (MPS) assesses progress made in containing inflation within the 3 – 6 percent medium-term objective range. The review considers key financial and economic developments that may influence the inflation outlook and the likely monetary policy response in the remaining part of the year. Publishing the Bank's inflation outlook and the prospective monetary policy stance helps to anchor public expectations of low, sustainable and predictable level of inflation.

1.2 The Bank defines price stability as a level of inflation that is consistent with sustainable long-run growth of the economy. Furthermore, low inflation that is close to trading partner inflation contributes to the stability of the real effective exchange rate (REER) which, in turn, supports the international price competitiveness of domestic producers and promotes economic growth.

1.3 Domestic output expansion was moderate in the first half of 2012, with the associated low demand pressures on inflation. As earlier anticipated, inflation fell in the first half of 2012, from 9.2 percent in December 2011 to 7.3 percent in June 2012. This reduction in inflation was influenced by factors such as the dissipation of the effects of last year's increase in administered prices (including fuel prices). The Bank Rate was unchanged at 9.5 percent for the period, as the medium-term outlook for price developments was positive. It is anticipated that inflation will fall within the 3 – 6 percent medium-term objective range in the second half of 2012.

1.4 Prospects for global economic recovery have deteriorated, due to uncertain developments in the Eurozone and the USA. World output growth is constrained by the ongoing fiscal consolidation measures, lower private sector investment, weak housing markets and high unemployment rates in major economies. Moreover, economic expansion in emerging market economies is expected to moderate on account of weaker external demand and volatile capital inflows. World GDP growth is, therefore, projected to ease from 3.9 percent in 2011 to 3.5 percent in 2012 and recover to 3.9 percent in 2013, mostly underpinned by strong growth in emerging market and developing economies.

2. Monetary Policy Framework

2.1 The Bank's monetary policy objective is to achieve price stability, defined as sustained low inflation within the medium-term objective range of 3 – 6 percent. Low and predictable level of inflation contributes to durable economic growth and development which entails, among others, the promotion of savings mobilisation, productive investment and international competitiveness of domestic producers.

2.2 The monetary policy framework involves a forecast-based and forward-looking strategy that focuses on the medium term (three-year rolling period), which is a reasonable *timeframe over which monetary policy can influence price developments. The medium-term forecast for inflation is derived from an assessment of current and future developments for various determinants of inflation, including domestic demand conditions, changes in prices of imports and exchange rate movements, adjustment of administered prices and consumption taxes, as well as public expectations of the rate of price changes.*

2.3 *The Bank uses interest rates and open market operations to influence the cost and availability of loanable funds in order to affect the demand for goods and services (relative to supply capacity) and, ultimately, price developments. In this regard, the policy response to pressures on inflation is based on an evaluation of the sources of inflation and the likely impact on prospective price developments. In particular, a distinction is made between factors that have a transitory impact*[1]*, such as changes in administered prices and consumption taxes, and those that are likely to have a lasting effect on inflation, (e.g. changes in demand conditions) and are subject to monetary policy influence. This approach to policy formulation facilitates appropriate and timely responses to any forecast lasting deviation of inflation from the objective range. In addition, the alternative measures of inflation (headline inflation, 16 percent trimmed mean and inflation excluding administered prices) play an important role in explaining the sources of inflation.*

2.4 *Achieving the inflation objective has an important benefit of contributing to the stability of the REER, which supports international competitiveness of domestic industries. In the event that the inflation objective is higher than forecast inflation in trading partner countries, the crawling band exchange rate arrangement facilitates a gradual downward adjustment of the nominal effective exchange rate (NEER) in order to maintain REER stability.*

2.5 *There is a regular review of monetary policy undertaken by the Monetary Policy Committee (MPC), which meets six times a year to assess the current and prospective economic developments that influence the outlook for inflation. This facilitates a timely response to anticipated economic and other events that would result in a significant and lasting deviation of inflation from the objective range.*

2.6 *The Bank's monetary policy framework and implementation are communicated to the public through the publication of the annual Monetary Policy Statement, MTR of the Statement and a press release following each MPC meeting. Such communication fosters policy transparency, accountability and credibility. It also enhances the degree to which the Bank is likely to succeed in influencing expectations of price stability.*

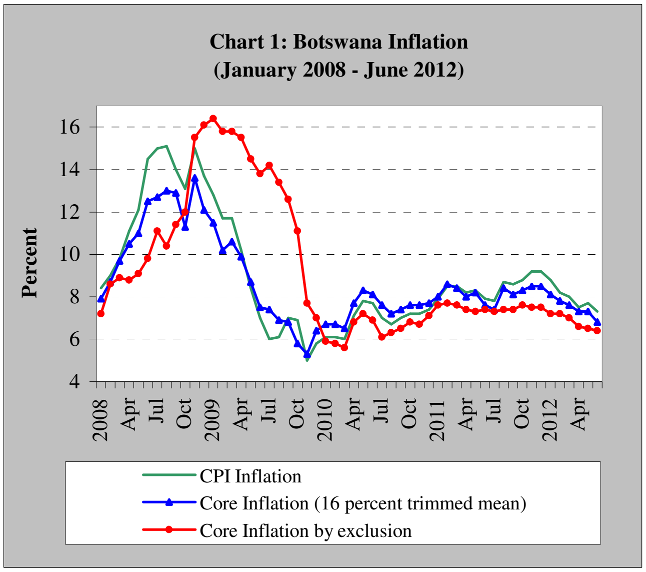
---

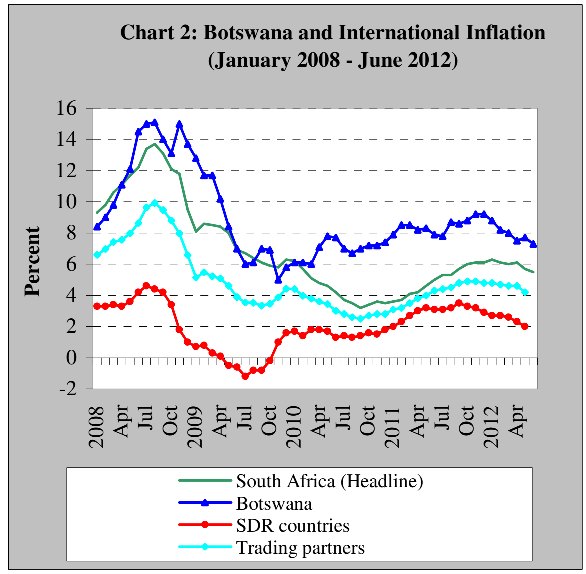
[1] *Monetary policy does not normally respond to these factors since the medium term is the relevant time frame for monetary policy to have an effect on the level of prices.*

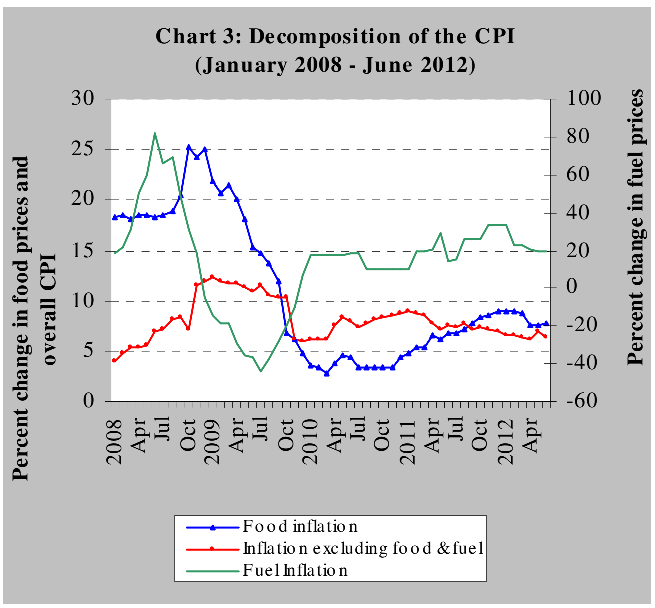
3. Inflation in the first half of 2012

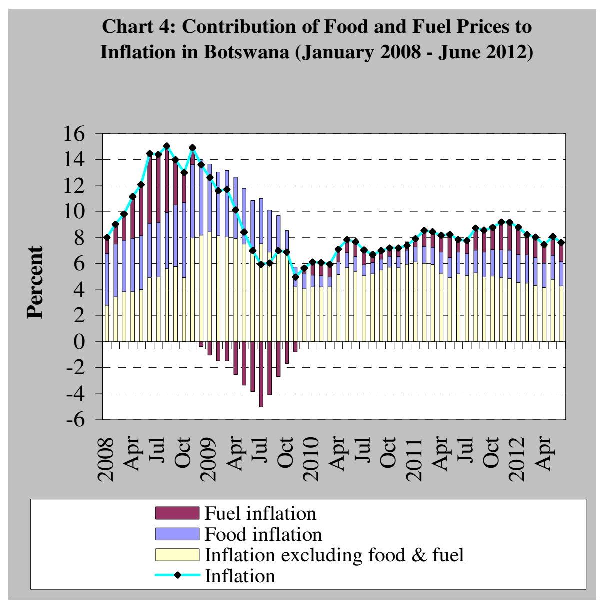
3.1 Average inflation in trading partner countries decreased from 4.8 percent in December 2011 to 3.9 percent in June 2012 as oil and food price increases moderated. Developments in food and oil prices also contributed to the decline in headline inflation in South Africa, from 6.1 percent in December 2011 to 5.5 percent in June 2012, thus falling within the South African Reserve Bank's target of 3 – 6 percent. For the SDR countries (USA, UK, Japan and Eurozone), inflation fell from 2.9 percent in December 2011 to 1.9 percent in June 2012 (Appendix I (Chart A3) shows inflation rates for SDR countries).[2]

[2] *Considerable variation in price developments remains across constituent economies. For instance, UK inflation was significantly higher than that of other SDR countries throughout 2010, 2011 and in the first half of 2012, while Japan, which experienced deflation for most of 2011, experienced moderate inflation in the first half of 2012.*









Source: Statistics Botswana and Bank of Botswana

3.2 *Domestic inflation trended downwards in the first half of 2012, falling from 9.2 percent in December 2011 to 7.3 percent in June 2012. With respect to the core measures of price change, inflation excluding administered prices decreased from 7.5 percent in December 2011 to 6.4 percent in June 2012, and the 16 percent trimmed mean inflation decreased from 8.5 percent to 6.8 percent in the same period. This general inflation decrease is, in part, due to the dissipation of the impact of the 2011 increase in administered prices. Moreover, the rate of price increase was lower for a wide range of goods and services (notably fuel and food prices) in the first half 2012.*

3.3 *Demand pressures on inflation remained low in the first half of 2012 in the context of below-trend domestic economic activity. In particular, household demand was restrained due to weak growth in incomes. In addition, the increase in government expenditure was modest at 5 percent in fiscal year 2011/12 and a similar level of spending is budgeted for fiscal year 2012/13 (0.1 percent decrease). However, significant growth in credit helped stabilise demand and support economic activity, although the rate of annual credit expansion eased from 26.4 percent in December 2011 to 25.4 percent in June 2012. The deceleration in credit growth was due to the lower rate of increase in lending to businesses (36.9 percent to 24.7 percent in the same period because of base effects) following a decline in credit to this sector in May 2011. On the other hand, the year-on-year increase in credit to households rose from 18.8 percent at the end of 2011 to 25.9 percent in June 2012.*

3.4 *Important developments in the credit market, which include measures undertaken by the central bank to reduce the amount of Bank of Botswana Certificates and initiatives by banks to expand the credit market, were aimed at increasing access to commercial bank lending and catering for possible substitution of slow growth in incomes with bank lending. In the circumstances, the intermediation ratio (the proportion of deposits at commercial banks that is converted to loans) rose from 58.1 percent in June 2011 to 68.3 percent June 2012.*

3.5 *Overall, broad money supply rose by 8.8 percent in the year to June 2012, thus reflecting the expansionary impact of the 16.8 percent increase in credit and 9 percent increase in net foreign assets. In contrast, the 3.6 percent increase in government deposits at the Bank of Botswana was contractionary. Thus, money supply growth supported output expansion, which is estimated at 4.3 percent in the twelve months to March 2012, mostly buoyed by the 7.2 percent increase in non-mining GDP. The leading sectors were construction (23.7 percent) and manufacturing (10.1 percent). Quarter on quarter, GDP rose by 3.1 percent in the three months to March 2012, with mining output rising by 4.4 percent. The non-mining sectors grew by 2.6 percent in the same period, with significant contributions to growth by the social and personal services (5.9 percent), construction (4.7 percent) and water and electricity (3.5 percent) sectors. The agriculture and manufacturing sectors' output fell by 5.9 percent and 2.2 percent, respectively, in the first quarter of 2012.*

4. Monetary Policy Implementation in the First Half of 2012

4.1 *Monetary policy was conducted in an environment of heightened global uncertainty and downside risks to economic activity, where growth rates were divergent across regions and countries. The policy focus revolved around mitigating the negative short-term effects of fiscal consolidation and bank deleveraging[3] on economic activity, particularly in major economies. Sovereign credit rating agencies downgraded several countries (particularly in the Eurozone) as well as some banks' ratings (including the European Financial Stability Facility), thus raising borrowing costs and constraining funding of*

[3] *Deleveraging refers to a reduction in assets through sales and reduced lending. This leads to contraction in credit, thus serving as borrowing constraints for businesses, and consequently resulting in weaker economic activity.*

economic activity. Although emerging market and developing economies grew at a faster rate compared to major economies, there was some deceleration in output expansion due to weaker external demand and volatile capital inflows. Meanwhile, global inflationary pressures were generally restrained owing to low levels of capacity utilisation, high rates of unemployment and well-anchored inflation expectations in major economies. Furthermore, risks to inflation associated with higher international oil and food prices eased as the increase in commodity prices moderated.

4.2 *In the circumstances, monetary policy in major economies was generally accommodative, with most central banks, including the US Federal Reserve Bank, Bank of England (BoE), Bank of Japan and European Central Bank (ECB), maintaining policy interest rates at low levels or reducing them. In addition, central banks took measures to inject liquidity into economies through increasingly longer maturity of funding commitments, quantitative easing, and reduction of reserve requirement ratios.*

4.3 *In emerging market economies, tighter monetary policy in place earlier in the year to counter high inflation were reversed with several central banks reverting to a more accommodative posture, against the background of weaker external demand and concerns about depressing domestic economic activity. Policy interest rates were reduced in Brazil, India and China in the first half of the year. In addition, reserve requirement ratios were lowered in China and India, while the South African Reserve Bank cut the official rate (Repo rate) by 50 basis points in July 2012.*

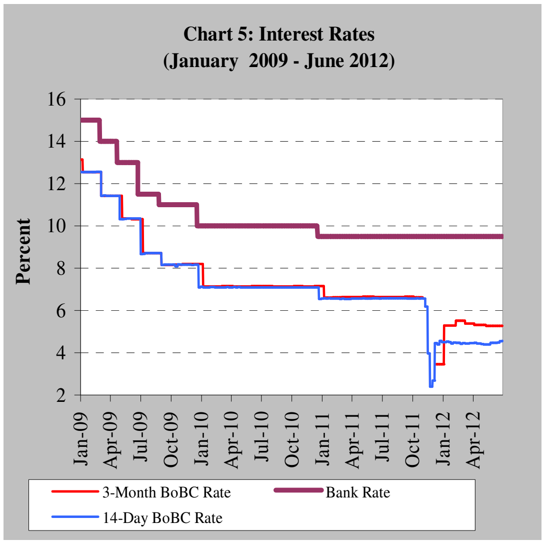
4.4 *Monetary policy in Botswana was implemented in the context of below-trend output, which implied a non-inflationary negative output gap. Furthermore, domestic demand pressures were modest, given the moderate pace of monetary expansion and sluggish growth in both personal incomes and government spending.*

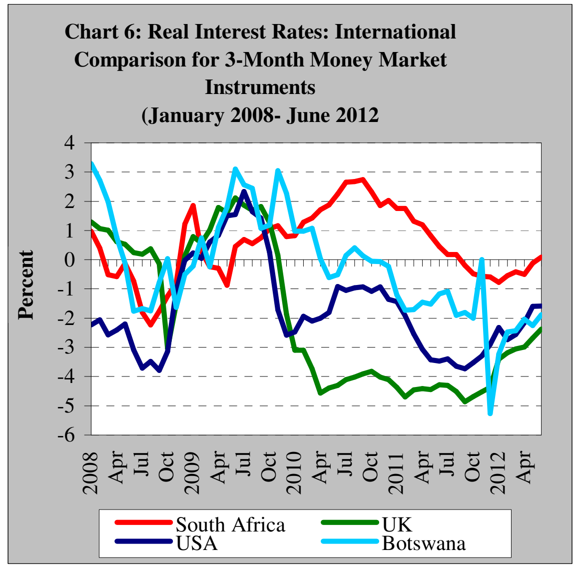
4.5 *Inflation was forecast to remain above the objective range in the short term, but with positive prospects in the medium term. The Bank Rate was, therefore, maintained at 9.5 percent in the first half of 2012. Given the unchanged monetary policy stance, money market interest rates were largely stable (Chart 6).[4] As such, the yield on the 14-day Bank of Botswana Certificate (BoBC) increased slightly from 4.50 percent at the end of December 2011 to 4.56 percent in June 2012, while the 3-month BoBC[5] yield rose from 3.45 percent to 5.28 percent in the same period. The prime lending rate of commercial banks was constant at 11 percent between December 2011 and June 2012, and the 88-day deposit rate fell from 4.08 percent in December 2011 to 3.52 percent in June 2012.*

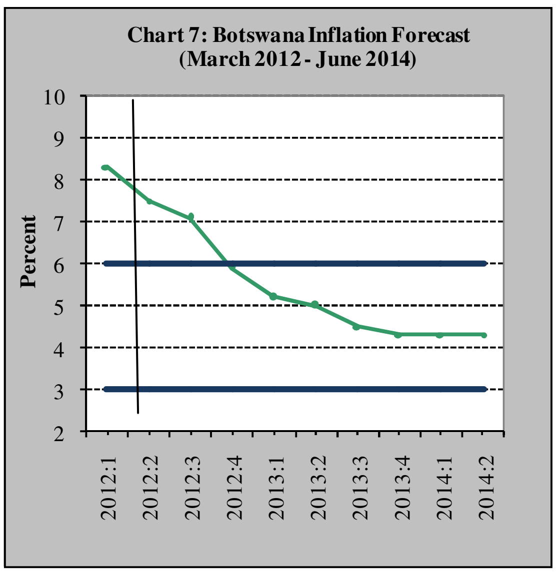
---

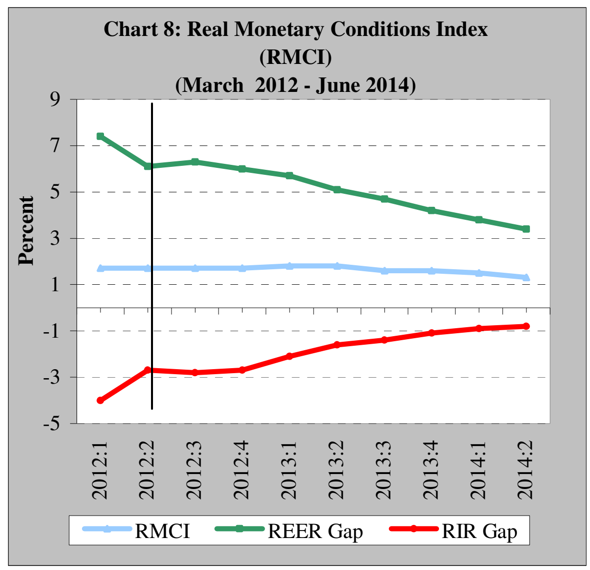
4 *Quoted yields are based on the weighted average of the winning bids at auction.*

5 *The yield on the 3-month BoBC rate fell from 6.62 percent in October 2011 to 3.45 percent in December 2011, following the reduction of BoBCs issued to P10 billion.*









Source: Bank of Botswana.

4.6 *As a result of the decrease in inflation between December 2011 and June 2012, real interest rates rose but remained negative. The 3-month BoBC real interest rate increased from -5.27 percent in December 2011 to -1.88 percent in June 2012. Similarly, the real interest rate for the 14-day BoBC rose from -4.3 percent in December 2011 to -2.55 percent in June 2012. At the same time, the real prime lending rate increased from 1.65 percent in December 2011 to 3.45 percent in June 2012, while the real 88-day deposit rate went up from -4.69 percent to -3.52 percent.*

4.7 *Domestic inflation was higher than the average inflation of trading partner countries, hence the nominal exchange rate of the Pula crawled downwards. Consequently, the nominal effective exchange rate depreciated by 1.2 percent in the six months to June*

2012. Bilaterally, the Pula depreciated by 1.6 percent against the SDR (weakening by 2.7 percent against the US dollar), and by 1 percent against the rand. The REER[6] of the Pula appreciated modestly by 0.2 percent in the six months to June 2012 due to the positive inflation differential between Botswana and her trading partner countries being greater than the rate of crawl of the NEER.

4.8 *Movements in interest rates and the Pula exchange rate are reflected in changes in the real monetary conditions index, which is a measure of the relative tightness or easiness of financing conditions in the economy. In the first half of 2012, the real interest rate gap was negative, thus implying easy financing conditions. However, this effect was more than offset by the restrictive positive real exchange rate gap. Overall, real monetary conditions were relatively tight, albeit stable throughout the first half of 2012.[7]*

5. Medium-Term Inflation Outlook

5.1 *The forecast for inflation entails an assessment of prospective changes in factors that affect domestic price movements, including demand-pull pressures resulting from real economic activity, imported inflation and other exogenous factors, such as changes in administered prices. The external influences on domestic prices include economic and financial developments in South Africa (Botswana's major trading partner) and global events, such as changes in international commodity prices and demand in major markets.[8]*

5.2 *There is uncertainty about the recovery of the global economy. World output is projected to expand by 3.5 percent in 2012 (compared to 3.9 percent in 2011); it is forecast to register growth of 3.9 percent in 2013. The overall moderation in the global economic expansion reflects the impact of fiscal consolidation measures, weak labour and housing markets and high unemployment rates that constrain growth in major economies, as well as slower growth in emerging market economies due to weaker external demand. Furthermore, weaker output growth and the uncertain fiscal stance in the US have a significant negative spillover to the rest of the world. Other downside risks to global economic activity arise from weak potential for financing economic activity and intermediation in Europe due to economic and policy uncertainty in the area.[9]*

---

6 *The REER is calculated using Botswana's headline inflation, weighted average inflation for SDR countries and South African headline inflation.*

7 *Real monetary conditions measure the relative easiness or tightness of monetary policy and gauge the effect that monetary policy has on the economy through changes in the exchange rate and interest rates. The real monetary conditions are measured by an index (RMCI) that combines, through a weighted average, the deviations of the real exchange rate and real interest rate from their trend values. Meanwhile, a positive change in the real effective exchange rate indicates an appreciation of the Pula against the basket of currencies (rand and SDR) in real terms.*

8 *Forecasts for external variables are obtained mainly from the Reuters survey of forecasters.*

9 *The political and financial uncertainty in Greece, banking sector problems in Spain, and doubts about the Eurozone member countries' willingness to help have heightened financial market stress. However, the agreement made at the European Council meeting in June 2012 (which includes forming a single Eurozone bank supervisory mechanism, recapitalising banks directly through the European Stability Mechanism and*

5.3 *World inflationary pressures have eased due to slower increase in commodity prices and persistent low levels of capacity utilisation and high unemployment rates in major economies. Overall, it is projected that pressure on prices globally will be restrained in the medium term. Forecast inflation in SDR countries is 2 percent and 1.7 percent for 2012 and 2013, respectively, while world inflation is projected to ease from an average of 4.8 percent in 2011 to 4 percent in 2012 and 3.7 percent in 2013.*

5.4 *Oil prices fell in the second quarter of the year, reflecting adequate supply and market concerns about the growth of the world economy and weak demand.[10] It is projected that the international price of oil will average USD95 per barrel in the second half of 2012, mainly influenced by the weak world economic outlook. On the other hand, food prices stabilised at lower levels in June 2012 compared to 2011 prices. However, severe drought in the US, which is the largest exporter of corn and wheat, is exerting upward pressure on some prices, thus raising fears of a global food crisis. Nonetheless, the regional outlook indicates satisfactory conditions for the second half of 2012, mainly due to average/above average harvest in most countries, and this implies subdued pressure on domestic inflation. Overall, it is expected that external price developments will have a benign influence on domestic inflation.*

5.5 *South Africa's GDP is projected to grow by 2.6 percent in 2012, compared to 3.1 percent in 2011. The lower forecast GDP expansion reflects slower growth of manufacturing output and a contraction in mining production. Inflationary pressures are expected to remain subdued, owing to lower food and fuel inflation, although the depreciation of the rand due to investor risk aversion poses an upside risk. Therefore, headline inflation is projected to remain within the 3 - 6 percent inflation target range to the end of 2014.*

5.6 *The stable inflation differential between Botswana and her trading partner countries implies maintenance of a modest downward crawl in the remainder of 2012. However, market forecasts suggest that the rand will depreciate in the short term, with the resultant appreciation of the Pula against the South African rand exerting marginal downward influence on domestic inflation.*

5.7 *Modest and below-trend domestic output growth is projected going forward, with good performance of some of the non-mining sectors continuing in the short- to medium-term. The projected negative output gap will result in modest demand pressures on inflation in the medium term. The March 2012 Business Expectations Survey also suggests that businesses anticipate a slower growth for the economy and indicates a decrease in overall business confidence from 54 percent (September 2011) to 51 percent. The surveyed businesses anticipated a moderation in inflation towards the objective range in the medium term.*

---

purchasing bonds of troubled Eurozone countries) has supported market sentiment, although details pertaining to the agreement are still to be decided.

[10] *Lower oil prices reflected robust production in Saudi Arabia, which has been sufficient to offset supply constraints arising from sanctions against Iran. The US light crude price was slightly above USD100 per barrel on average in the first four months of 2012, before falling to USD82 per barrel at the end of June.*

5.8 The announced increase in administered prices is estimated to add 1.25 percentage points to inflation in the short term, with most of the effect dissipating in the first half of 2013. The increase in fuel prices in May 2012 initially added 0.44 percentage points to inflation, while the upward adjustment of water tariffs added 0.38 percentage points to inflation in May. The projection also includes a possible increase in electricity tariffs in the third quarter of 2012 which will initially add around 0.43 percentage points to inflation. Although the impact of this year's price increase will continue into 2013, the effect of the earlier price adjustment is such that inflation will fall within the objective range towards the end of 2012 (Chart 7). The large increase in administered prices, in the context of falling real incomes, also depresses demand and reduces pressure on underlying inflation. Upside risks to the inflation outlook include any substantial increase in administered prices and government levies, as well as any increase in international oil and food prices beyond current forecasts. However, inflation could be positively affected by a further slowdown in global economic activity.

6. Monetary Policy Stance

6.1 In line with the Bank's forward-looking framework, the Bank's monetary policy response takes into account the likely impact of economic activity and associated demand on future price developments (inflation forecast). Below-trend economic performance (negative output gap) is associated with reduced or low pressure on inflation and could signify a need to provide monetary policy stimulus to support economic growth, while economic activity that is above trend is likely to result in an increase in inflation and could require monetary policy tightening to dampen inflation.

6.2 It is expected that economic activity will remain below trend in the medium term, influenced by moderation in global economic expansion and reduced government spending. Moreover, it is projected that demand and its impact on economic activity will be constrained by the slow growth in personal incomes and the increase in administered prices and government levies, which will have a negative impact on real disposable incomes. Against this background, it is expected that inflation will fall within the 3 – 6 percent objective range before the end of 2012.

6.3 In assessing the monetary policy stance, the Bank also considers developments in real interest rates and real exchange rates that define monetary conditions in the economy, which ultimately have an impact on domestic demand. Real monetary conditions tightened somewhat in the first half of 2012, largely due to real exchange rate developments, but this was partially offset by the maintenance of constant nominal interest rates. Looking ahead, the real exchange rate and real interest rate gaps suggest an easing of real monetary conditions in the medium term (Chart 8). Therefore, the current state of the economy and expectations relating to the domestic and external economic prognosis, along with the positive inflation outlook, suggest that maintaining the existing monetary policy stance is consistent with the attainment of the 3 – 6 percent inflation objective in the medium term. As such, monetary policy would be supportive of economic recovery in an environment where the impact of the expansionary fiscal policy is limited by restrained government spending. This policy stance could, however, change in response to indications that expectations of high inflation are becoming entrenched.

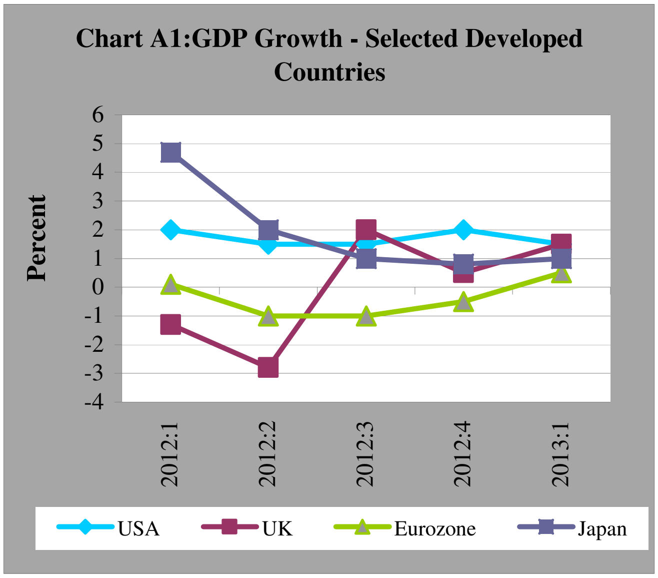
7. Summary and Conclusions

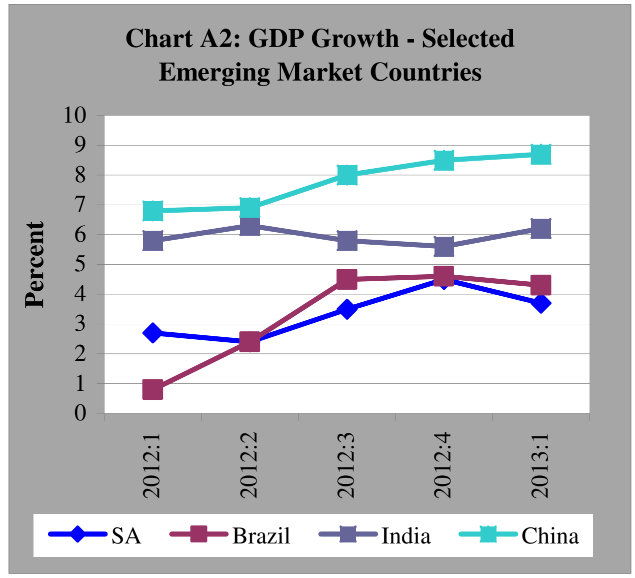
7.1 Inflation was above the objective range in the first six months of 2012, influenced mainly by the lingering impact of the increase in administered prices in 2011 and further adjustment of some of these prices in the first half of 2012. Both domestic demand and external inflationary pressures remained low. Given the positive medium-term outlook for price developments, the Bank Rate was unchanged at 9.5 percent between December 2010 and June 2012.

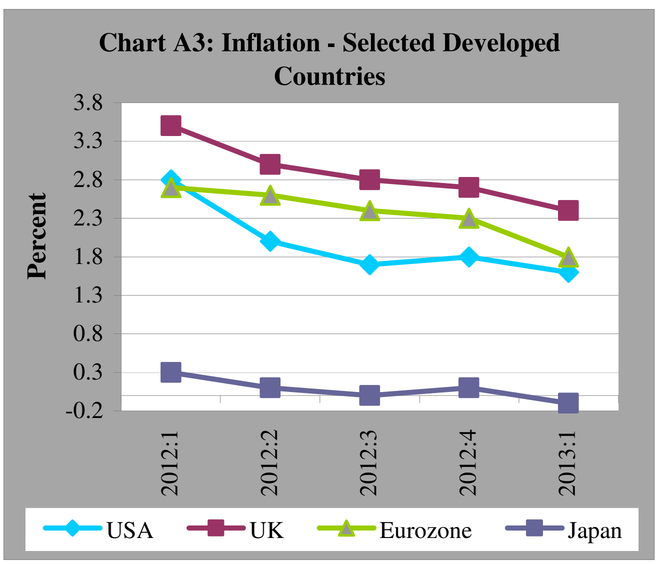
7.2 Going forward, external price pressures should remain generally benign in the context of restrained world economic activity, modest commodity price inflation (although there is a renewed risk pertaining to rising food prices) and the dampening impact of low levels of capacity utilisation, high rates of unemployment and well-anchored inflation expectations in major economies. Domestically, subdued fiscal stimulus, sluggish income growth and below-trend performance of the economy will constrain demand pressures on inflation. The risks to the inflation outlook emanate from any possible large increase in administered prices and government levies, as well as any increase in international food and oil prices beyond current forecasts. Meanwhile, the possible decline in world economic activity poses downside risks to the outlook.

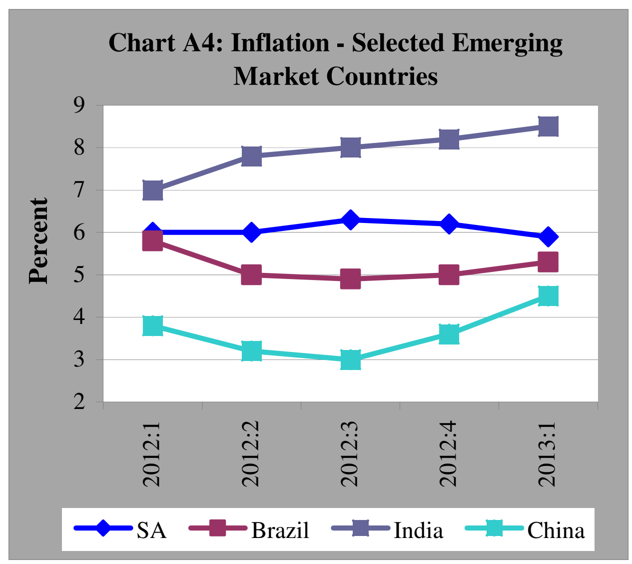
7.3 Accordingly, an accommodative monetary policy stance is consistent with the achievement of the 3 – 6 percent inflation objective in the medium term, and remains appropriate for supporting economic recovery, including sustenance of robust performance of the non-mining sectors. The Bank will continue to monitor economic and financial developments with a view to responding appropriately to ensure medium-term price stability, without undermining economic recovery and growth.

Output Growth and Inflation for Selected Countries









Source: JP Morgan Chase
Note: Data from 2012Q3 to 2013Q1 are forecasts