MID-TERM REVIEW OF THE

2014 MONETARY POLICY STATEMENT

1. INTRODUCTION

1.1 The Mid-Term Review (MTR) of the 2014 Monetary Policy Statement (MPS) examines recent price developments and reviews key financial and economic developments that are likely to affect the inflation outlook and, therefore, the Bank's monetary policy responses in the second half of 2014. In this way, the Bank seeks to promote policy credibility and understanding of monetary policy with a view to anchoring public expectations of a low, predictable and sustainable level of inflation in the range of 3 – 6 percent.

1.2 Domestic output expansion was moderate in the first half of 2014, and demand pressures on inflation were low. As projected at the launch of the 2014 MPS, inflation remained within the objective range in the first six months of 2014, having increased from 4.1 percent in December 2013 to 4.6 percent in June 2014.[1] On account of the positive medium-term outlook for price developments, the Bank Rate was maintained at 7.5 percent in the first half of 2014.

1.3 Global economic activity continues to increase gradually, as supported by accommodative monetary policy, improving demand and unwinding of austerity programmes in advanced countries, as well as sustained overall robust growth rates in emerging market economies. Therefore, world GDP growth is projected to increase from an estimated 3.2 percent in 2013 to 3.4 percent in 2014, and by 4 percent in 2015.[2]

2. MONETARY POLICY FRAMEWORK

2.1 The primary objective of 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

---

1 *Inflation fell to 4.5 percent in July 2014.*

2 *The International Monetary Fund's World Economic Outlook (WEO) Update, July 2014. The growth rates were computed using revised purchasing power parity (PPP) weights; they are a downward revision to world GDP projections for 2014.*

financial system. The Bank recognises that developmental aspects, including balanced economic growth, enhanced financial inclusion (with respect to both households and businesses) and financial well-being help promote financial stability and effective transmission of policy to achieve price stability. A low and predictable level of inflation and a conducive financial environment foster savings mobilisation, productive investment and international competitiveness of domestic producers, and thus contribute towards the broader national objective of sustainable economic growth and development.

2.2 *The monetary policy framework is forecast-based, with a medium-term outlook that guides the Bank's response to projected movements in inflation, while taking into account prospects for economic growth and developments with respect to financial indicators. The main elements of the policy framework are as follows:*

(a) *generation of a broad-based medium-term inflation forecast, including a projection of the "output-gap"* [3]*, assessment of "real monetary conditions"* [4] *and an estimate of the impact of any anticipated changes in administered prices and government levies;*

(b) *assessment of any relevant information not incorporated in the inflation forecast, including the biannual Business Expectations Survey and other supplementary data sources;*

(c) *evaluation of financial and other indicators that can impact on the stability of the financial system, including credit, liquidity conditions and property market developments, as well as economic growth and employment prospects;*

(d) *regular meetings of the Bank's Monetary Policy Committee (MPC) to review recent economic developments, the related inflation outlook and implications for monetary policy, accompanied by prompt dissemination of decisions to foster policy credibility and help anchor inflation expectations;*

(e) *use of interest rates and open market operations to affect demand conditions in the economy and, ultimately, the rate of increase in prices*[5]*. In general, the Bank responds to a sustained deviation of inflation from the objective range, and where the causal factors could be influenced by domestic monetary policy; and*

---

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

[4] *The real monetary conditions index (RMCI) 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 real monetary conditions are measured by the RMCI that combines, through a weighted average, the deviations of the real exchange rate and real interest rate from their respective trend values.*

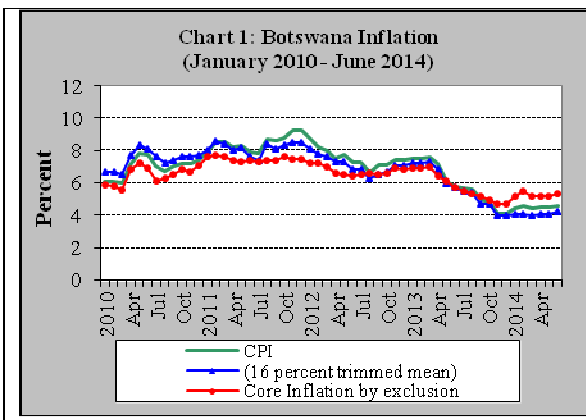
[5] *For example, a sustained level of economic performance above trend is potentially inflationary and could signal the need to increase interest rates to dampen inflationary pressures, while output below trend could require a reduction of interest rates to stimulate economic activity.*

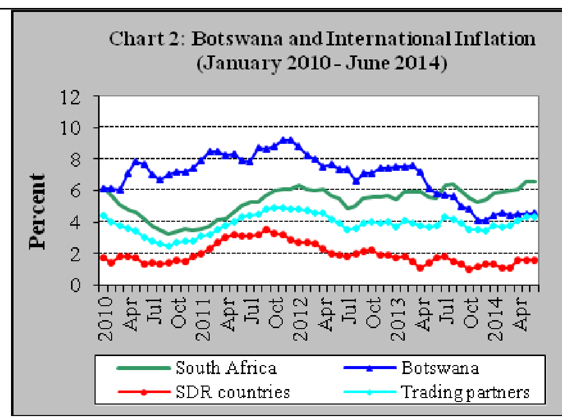
(f) *monitoring of exchange rate developments and implementation of the crawling band exchange rate policy to support competitiveness of local producers.*

3. INFLATION IN THE FIRST HALF OF 2014

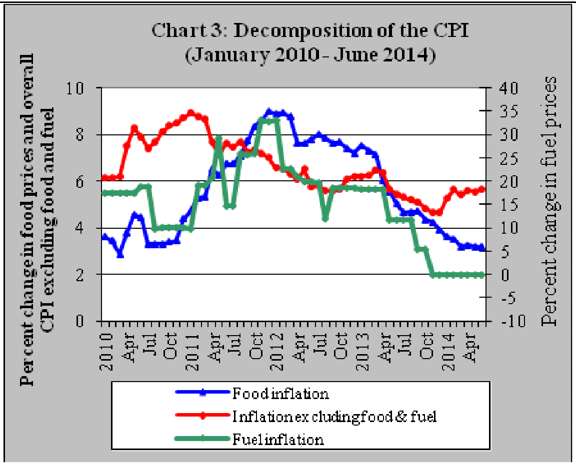
3.1 World inflation was subdued in the first half of 2014 owing to modest economic activity, persistent capacity underutilisation and stable commodity prices. Relatively high unemployment rates in major economies also moderated wage inflation and demand pressures on prices. However, there was upward pressure on inflation in some emerging market economies due to currency depreciation associated with capital outflows. For Botswana's trading partner countries, average inflation increased from 3.4 percent in December 2013 to 4.3 percent in June 2014. In South Africa, inflation increased from 5.4 percent in December 2013 to 6.6 percent in June 2014, thus breaching the target range of 3 – 6 percent. For the SDR countries, inflation increased from 1.3 percent to 1.6 percent in the same period.[6]

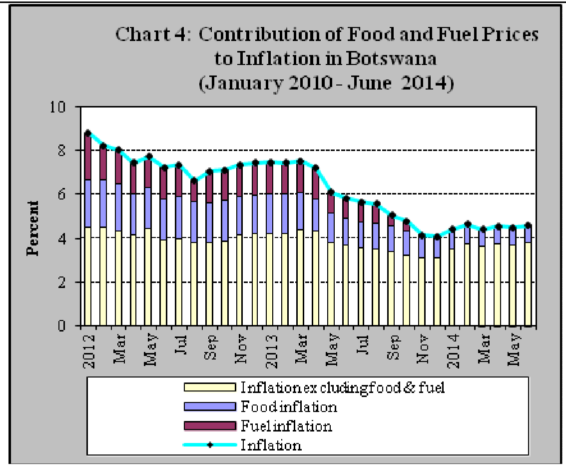
3.2 Inflation in Botswana was within the Bank's objective range of 3 – 6 percent in the first half of 2014, having increased from 4.1 percent in December 2013 to 4.6 percent in June 2014 due, in part, to the impact of levies on alcohol and tobacco, as well as higher education and medical costs. The annual price increase was subdued for most categories of goods and services (notably food, transport and housing). The appreciation of the Pula against the South African rand also helped to moderate imported inflation. On the other hand, inflation excluding administered prices and the 16 percent trimmed mean measure of inflation showed an upward trend, from 4.7 percent and 4 percent in December 2013 to 5.3 percent and 4.2 percent in June 2014, respectively.





6 *Notable variation in price developments remains across the SDR constituent economies. For instance, UK and USA inflation rates were significantly higher than those of other SDR countries in the first half of 2014. Inflation fell significantly in the Euro area and generated concerns of deflation, while Japan experienced a notable increase in inflation, albeit from a low base.*





Source: Statistics Botswana and Bank of Botswana

3.3 *The demand pressures on inflation were moderate in the first six months of 2014, in this way reflecting restrained growth in government expenditure and personal incomes[7]. Total government expenditure increased by one percent in the year to April 2014, with development and recurrent spending growing by 3.9 percent and 0.3 percent, respectively, in the same period. Nevertheless, demand was buoyed by sustained strong credit growth, albeit slowing from 15.1 percent in December 2013 to 14.1 percent in June 2014. The deceleration in credit growth was due to a lower annual increase in borrowing by households (18.6 percent compared to 24.2 percent for December 2013 and June 2014, respectively), thus easing concerns about the pace of growth in household debt. It has been observed that household credit expansion has recently been driven by secured lending, mainly to real estate (residential property). In contrast, the annual growth in lending to the business sector increased from 4.6 percent at the end of 2013 to 8.7 percent in June 2014.*

3.4 *Nonetheless, the rate of household credit growth remains relatively high and continues to be monitored for its potential impact on demand, financial stability and consumer welfare. The current trend growth rate of credit is against the background of accommodative monetary policy and a scaling down of liquidity absorption through issuance of Bank of Botswana Certificates (BoBCs), given the need to encourage financing for viable bankable projects. Overall, the banking system indicators, including low default ratios for household borrowing, suggest a stable financial environment, with the aggregate ratio of non-performing loans to total loans increasing marginally from 3 percent in December 2013 to 3.1 percent in June 2014. In the context of the projected positive GDP growth[8], the current assessment is that there is a low risk of widespread loss of employment income that could trigger a significant increase in default rates. Thus, the current profile of household debt is consistent with the stable financial sector. The Bank will continue to monitor developments to ensure that this financial stability is not undermined by potentially excessive consumer debt.*

---

7 *The Government awarded civil servants a 4 percent salary increment in April 2014.*

8 *The Ministry of Finance and Development Planning projects GDP growth at 5.1 percent for both 2014/15 and 2015/16 (2014 Budget Speech).*

3.5 Growth in broad money supply increased by 7.8 percent year on year to May 2014, thus reflecting the impact of the 14 percent and 14.3 percent growth in credit[9] and net foreign assets respectively. The 31.9 percent increase in government deposits at the Bank of Botswana had a contractionary effect. At the same time, total output growth for the domestic economy is estimated at 5.9 percent in the twelve months to March 2014. The output expansion reflects a growth of 14.2 percent and 4.6 percent in the mining and non-mining sectors, respectively. The main contributors to non-mining sector growth are trade, hotels and restaurants (6.8 percent), social and personal services (5.1 percent), finance and business services, and general government (4.7 percent for both).

4. MONETARY POLICY IMPLEMENTATION IN THE FIRST HALF OF 2014

4.1 Globally, monetary policy was generally accommodative in the first half of 2014, as reinforced by forward guidance[10] and was implemented against the background of improving but uncertain/uneven growth prospects globally. Economies continue to introduce structural reforms to foster competitiveness and balanced growth, and regulatory reforms to promote financial sector resilience and effective support for economic activity. World inflation increased, but was moderated by stable energy prices (given adequate supply and minimal negative impact of geopolitical conflicts)[11], spare capacity in major economies, as well as subdued growth in global demand.

4.2 In the circumstances, the US Federal Reserve (Fed) [12], Bank of England (BoE), Bank of Japan (BoJ), and Reserve Bank of Australia maintained policy interest rates at low levels. The European Central Bank (ECB) reduced the policy rate in June 2014 and announced measures to encourage bank lending through targeted longer-term refinancing operations. Furthermore, major central banks maintained liquidity support alongside forward guidance.

4.3 In contrast, several emerging market economies tightened monetary policy in response to capital outflows and associated pressures on the exchange rate and inflation. Policy interest rates were, therefore, increased in South Africa, India and Brazil to reign in inflationary pressures in the first half of the year; the policy rate was unchanged in China.

---

9 Refers to credit offered by all deposit-taking institutions (commercial banks, Botswana Savings Bank and Botswana Building Society).

10 To guide expectations on data developments that would influence change in the policy stance.

11 Between December 2013 and June 2014, the Organisation of Petroleum Exporting Countries' reference crude oil basket price rose by 0.6 percent, Brent crude by 1 percent and West Texas Intermediate by 8 percent.

12 The US Federal Reserve System started tapering its asset purchase programme in January 2014 on account of improving macroeconomic fundamentals. It reduced the pace of its asset purchases by USD10 billion per month in the period January - August 2014.

4.4 *In Botswana, monetary policy implementation was in the context of below-trend GDP performance (negative output gap). Thus, domestic demand pressures were modest, partly indicative of subdued growth in personal incomes and slow growth in government expenditure. In addition, foreign inflation was low, with benign pressure on domestic prices. These factors contributed to a positive medium-term outlook for inflation; hence the Bank Rate was maintained at 7.5 percent in the first half of 2014.*

4.5 *The yield on the 14-day BoBC increased marginally from 3.06 percent at the end of December 2013 to 3.07 percent in June 2014, while the 3-month BoBC yield[13] eased from 3.58 percent to 3.25 percent in the same period, in the context of the Bank's preference to limit the supply of BoBCs in favour of encouraging banks to lend for productive purposes. Given the unchanged monetary policy stance, the prime lending rate of commercial banks was stable at 9 percent in the first half of 2014, while the average 88-day deposit rate fell from 2.58 percent in December 2013 to 2.47 percent in June 2014.*

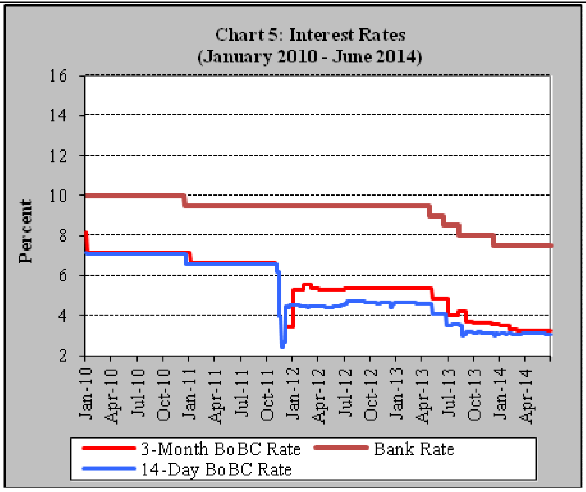
4.6 *The increase in inflation between December 2013 and June 2014 resulted in a decline in real interest rates. The real interest rate for the 3-month BoBC eased from -0.5 percent in December 2013 to -1.29 percent in June 2014. Similarly, the 14-day BoBC real interest rate decreased from -1 percent to -1.46 percent in the same period. Similarly, the real 88-day deposit rate fell from -1.46 percent in December 2013 to -2.04 percent in June 2014.*

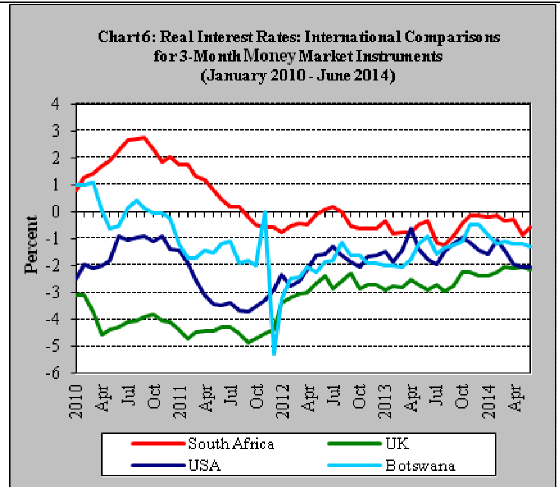
4.7 *The Bank implemented a modest downward crawl of the Pula exchange rate in line with the policy objective of maintaining a stable inflation-adjusted exchange rate of the Pula against a trade-weighted combination of currencies of trading partner countries. As the domestic inflation objective was higher than the projected average inflation of trading partner countries, a downward crawl was maintained. Therefore, the nominal effective exchange rate depreciated by 0.08 percent in the six months to June 2014. The Pula weakened by 1 percent against the SDR (0.8 percent depreciation against the US dollar), but appreciated by 0.7 percent against the South African rand in the same period. The REER[14] of the Pula depreciated by 0.23 percent in the six months to June 2014 due to Botswana's lower inflation relative to the average inflation of trading partner countries.*

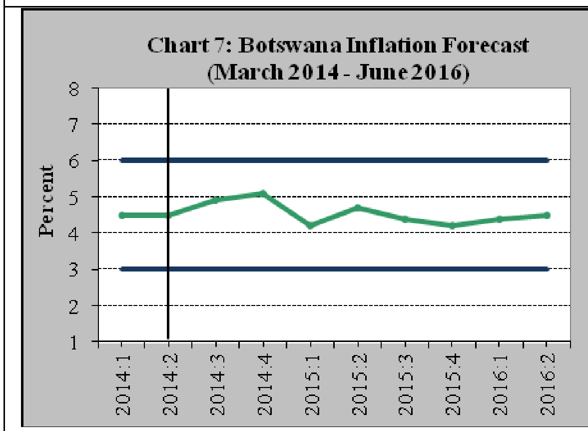
---

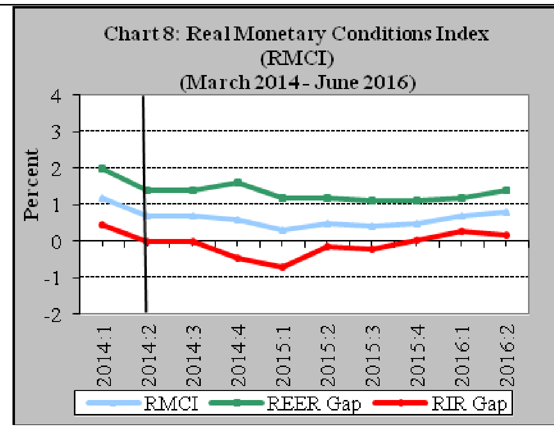
[13] *Quoted yields are based on the weighted average of the winning bids at auction.*

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









Source: Bank of Botswana.

4.8 *Overall, real monetary conditions were relatively tight in the first half of 2014, albeit reflective of an easing trend, given the narrowing of the positive real exchange rate gap and the negative real interest rate gap (Chart 8).*

5. *MEDIUM-TERM INFLATION OUTLOOK*

5.1 *The forecast for inflation entails an assessment of possible developments in factors that affect domestic price movements, namely, demand and supply relationships, imported inflation and other exogenous factors such as changes in administered prices and government levies. The external influences on domestic prices include economic and financial developments in South Africa and global events such as changes in international commodity prices and demand in major markets.*[15]

5.2 *It is anticipated that global economic growth will improve from 3.2 percent in 2013 to 3.4 percent in 2014. Output expansion in major economies is projected at 1.8 percent in 2014 (1.3 percent in 2013), while in emerging market economies growth is expected to slow down marginally from 4.7 percent in 2013 to 4.6 percent in 2014. However, there are significant downside risks to the growth projections emanating from possible*

---

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

escalation of geopolitical conflicts that could potentially have a negative impact on production and trade. In South Africa, GDP is forecast to grow by 1.7 percent in 2014 compared to 1.9 percent in 2013, and reflective of structural impediments, protracted labour disputes and deficient energy supply.

5.3 World inflation is projected to be restrained in the medium term, at an average of 3.5 percent in 2014 from 3.6 percent in 2013, before decreasing further to 3.4 percent in 2015, as influenced by stable commodity prices and spare capacity in advanced economies. It is anticipated that sufficient oil supply, as underpinned by the increase in non-OPEC production and the modest growth in global economic activity, will continue to dampen pressure on oil prices. Similarly, it is projected that food prices will be stable in the context of sufficient harvests and supply.

5.4 Inflation for trading partner countries is projected to average 4.1 percent in 2014, mostly reflecting persistent low inflation in SDR countries (1.5 percent), while headline inflation in South Africa is projected to average 6.3 percent, which would still be higher than the 3 – 6 percent inflation target range. It is anticipated that the relative strength of the Pula against the South African rand will moderate imported inflation. These developments point to expectations of external price developments having a benign influence on domestic inflation in the remaining part of 2014.

5.5 Botswana's output is projected to remain below trend, with modest overall growth in the non-mining sectors. The projected negative output gap will entail moderate demand pressures on inflation in the medium term. The modest increase in government expenditure and personal incomes, as well as the relatively slower growth in credit, also contributes to subdued pressure on inflation.

5.6 The increase in electricity prices in the second quarter of 2014 is estimated to have added 0.12 percentage points to inflation. Given a smaller number and lower rate of increase in administered prices in the first half of 2014 compared to 2013, the net outcome is a decrease in inflation due to base effects. Overall, it is expected that inflation will be within the objective range for the remainder of 2014 (Chart 7) and into the medium term.[16] Upside risks to the inflation outlook relate to 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 moderated by any further slowing of growth in global economic activity.

6. Monetary Policy Stance

6.1 In line with the forward-looking policy 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). Thus, in the context of moderate economic expansion, as well as the modest increase in government spending and personal incomes, it is expected that inflation will remain within the 3 – 6 percent objective range in the medium term.

16 As reported in the March 2014 Business Expectations Survey, businesses expect inflation to remain within the objective range for both 2014 and 2015.

6.2 *In evaluating the monetary policy stance, the Bank also considers developments in real interest rates and exchange rates that largely determine monetary conditions in the economy, which ultimately have an impact on domestic demand. Looking ahead, the real exchange rate and real interest rate gaps suggest that the real monetary conditions will be relatively tight in the medium term (Chart 8).*

6.3 *The current state of the economy and the projected GDP performance, as well as the positive inflation outlook, suggest that maintaining the existing monetary policy stance is consistent with attainment of the 3 – 6 percent inflation objective in the medium term. The current policy takes an appropriate balance between the need for monetary policy to provide some support for domestic economic activity in an environment where the expansionary impact of fiscal policy is limited by restrained government spending. At the same time, the policy has to take into account the need to maintain financial stability and the need for positive real interest rates. The Bank will continue to ensure that absorption of excess liquidity in the banking system through BoBCs does not undermine the need to effectively deploy financial resources for productive economic activity. Due to the projected stable and modest inflation differential between Botswana's inflation objective and the average inflation of trading partner countries, the 0.16 percent downward crawl of the NEER will be maintained for the remaining period of 2014.*

7. Summary and Conclusion

7.1 *Inflation was stable in the first half of 2014 and remained within the Bank's medium-term objective range of 3 – 6 percent, against the background of modest domestic demand and benign external inflationary pressures. The Bank Rate was maintained at 7.5 percent in the first half of 2014 to support economic growth in the context of the positive medium-term outlook for price developments.*

7.2 *Looking ahead, it is anticipated that external price pressures on domestic inflation will be benign, given the projected moderate expansion in world economic activity, stable commodity prices and the dampening impact of capacity underutilisation in major economies. The slow increase in personal incomes and below-trend performance of the economy are expected to moderate demand pressures on inflation. Consequently, an accommodative monetary policy stance is consistent with the achievement of the inflation objective in the medium term and remains appropriate for supporting a stronger economic expansion. The Bank remains committed to monitoring economic and financial developments with a view to responding appropriately to ensure price stability and financial stability, without undermining sustainable economic growth.*