MID-TERM REVIEW OF THE
2015 MONETARY POLICY STATEMENT

1. INTRODUCTION

1.1 The Mid-Term Review (MTR) of the 2015 Monetary Policy Statement (MPS) examines price developments and the underlying factors in the first half of 2015. It assesses key financial and economic developments that are likely to impact on the inflation outlook; it also assesses financial stability and, in turn, evaluates the likely monetary policy choices for the second half of 2015. This approach assists the Bank in promoting policy credibility and understanding of monetary policy with a view to anchoring public expectations of a low, predictable and sustainable level of inflation within the 3 – 6 percent objective range in the medium term.

1.2 As anticipated in February when the 2015 MPS was launched, inflation remained within the Banks's objective range for most of the first six months of 2015; inflation declined from 3.8 percent in December 2014 to 3.1 percent in June 2015; it breached the lower bound of the range in February and March, by decreasing to 2.8 percent. Domestic and external inflationary pressures were subdued in the context of weaker commodity prices, modest growth in global economic activity and restrained growth in personal incomes. On account of the positive medium-term outlook for price developments, the Bank Rate was reduced by 100 basis points to 6.5 percent in February 2015 and maintained at that level until it was reduced by 50 basis points in August 2015. Furthermore, in response to tighter liquidity in the banking system, the Primary Reserve Requirement was reduced from 10 percent to 5 percent effective April 2015.

1.3 At the time of the MPS launch, global economic growth for 2015 was forecast at 3.5 percent[1], thus reflecting a pick-up in growth in advanced economies, led by the United States of America (USA), while the pace of economic expansion in emerging market

[1] The International Monetary Fund's World Economic Outlook (WEO) Update, January 2015.

economies was expected to moderate. In the event, lower-than-expected growth in the first quarter, in the USA in particular, resulted in a modest downward revision to the forecast for global economic growth in 2015 to 3.3 percent.[2] *Nevertheless, economic activity in advanced countries is expected to expand gradually, with the forecast for global growth in 2016 unchanged at 3.8 percent, buoyed by accommodative monetary policy, easing financial conditions, low commodity prices (particularly oil), and improving confidence and labour market conditions.*

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. In this regard, the Bank recognises that further economic and social development, including balanced economic growth that results in sustained increase in household incomes and a greater degree of financial inclusion (for both households and businesses), contributes to the promotion of financial stability and effective transmission of monetary policy in support of 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, thus contributing towards the broader national objective of sustainable economic development.*

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 account of prospects for economic growth and developments in financial soundness indicators for monitoring and addressing risks to financial stability. To this end, in assessing the policy stance, the Bank considers projections of real monetary conditions*[3] *in*

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[2] *The International Monetary Fund's WEO Update, July 2015.*

[3] *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,*

the context of other relevant domestic and international considerations, and their impact on the output gap[4] *and, ultimately, on inflation. The policy framework recognises the importance of communication to inform stakeholders and influence expectations; as such, there is a Press Release after each of the regular Monetary Policy Committee meetings to announce the policy decision and the rationale for it.*

3. INFLATION IN THE FIRST HALF OF 2015

3.1 In the first half of 2015, global inflation was restrained due largely to low oil prices, a decline in other commodity prices, persistent excess capacity in major economies and weak demand in countries with below-target inflation, notably, the euro area and Japan. However, to an extent, this was offset by rising inflation in some emerging market economies due to the sizeable currency depreciation associated with capital outflows. For Botswana's trading partner countries[5]*, average inflation decreased from 3.1 percent in December 2014 to 2.4 percent in June 2015. In particular, for the same period, South African inflation remained within the South African Reserve Bank's target range of 3 – 6 percent (having moved from 5.3 percent to 4.7 percent) while for SDR countries, inflation decreased from 0.5 percent to 0.1 percent.*[6]

3.2 Oil prices recovered from an average low level of USD44 in January to around USD57 per barrel early in the second quarter of 2015 (Chart 1), against the background of a reduction in shale oil production in North America and concerns about a possible

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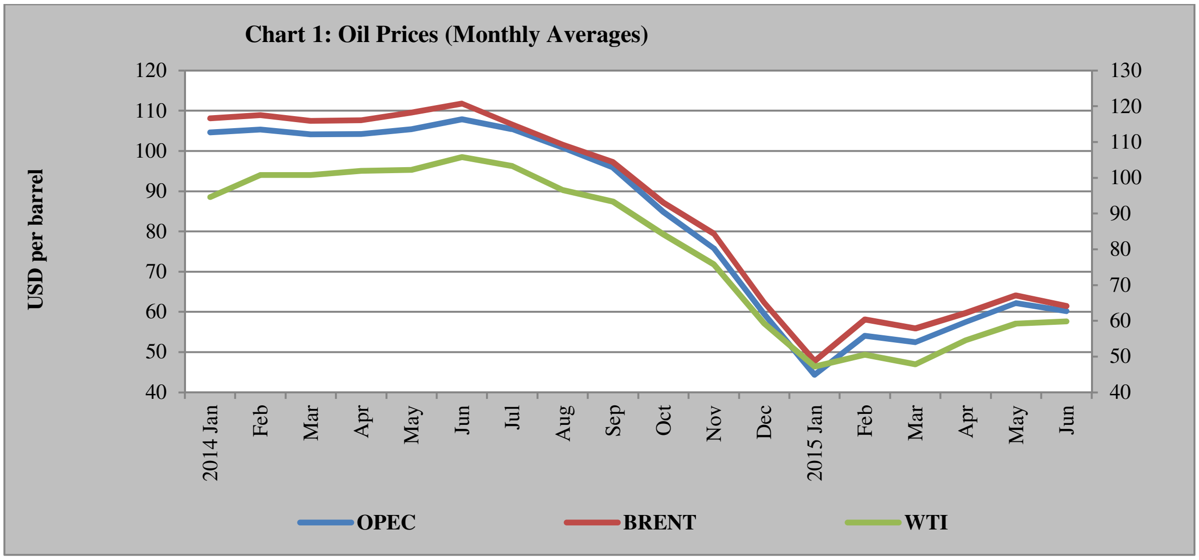
through a weighted average, the deviations of the real exchange rate and real interest rate from their respective trend values.

4 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. A positive output gap is the converse outcome.

5 South Africa and the SDR countries (euro area, Japan, UK and USA).

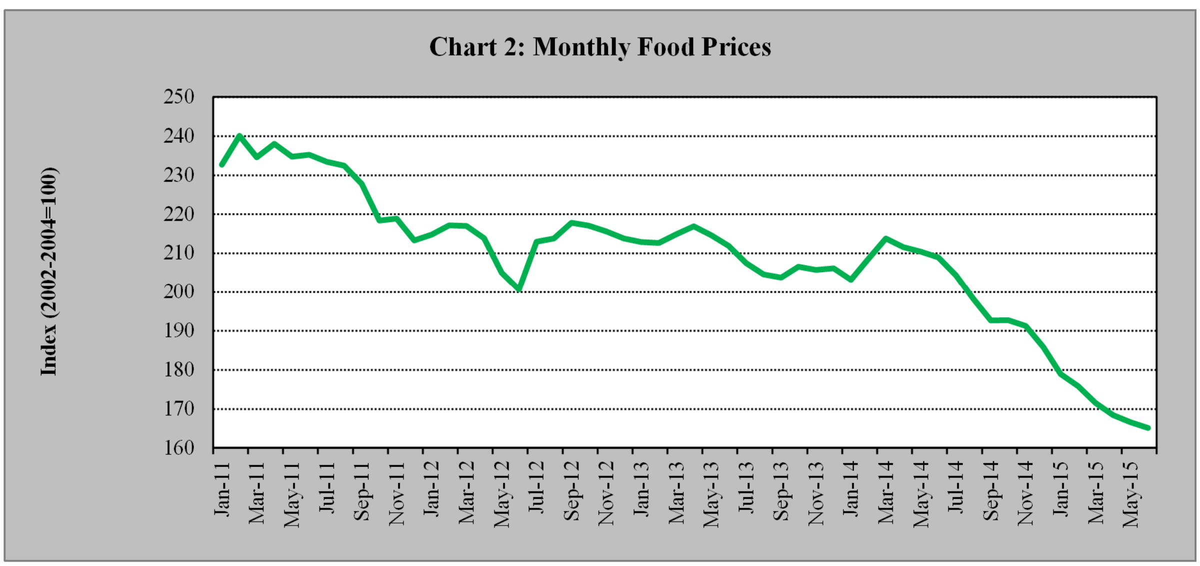
6 A notable downward trend in prices remains across constituent economies. Notably, UK, USA and the euro area inflation rates were very low in the first half of 2015, and in some instances negative, thus engendering concerns of deflation, while positive inflation in Japan declined in the same period.

disruption to one of the busiest channels for shipping oil due to the conflict in Yemen. Oil prices rose further and stabilised at an average of about USD60 per barrel in June 2015, in this way reflecting a well-supplied market and subdued demand. International food prices declined by 11.2 percent in the first half of 2015 (Chart 2). Prices decreased over the period for all constituent food items (meat, cereals, sugar, oils and dairy products).



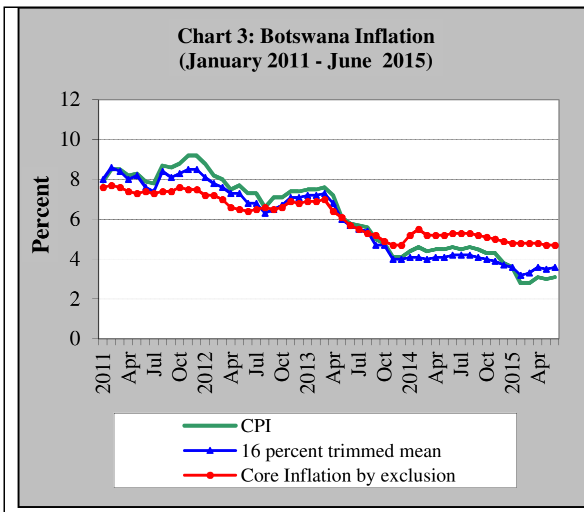
Source: OPEC and U.S Energy Information Administration

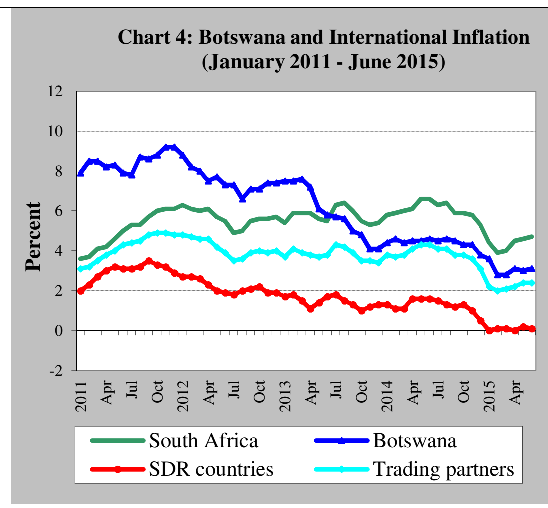
Note: Brent and WTI are international benchmark crude oils, while OPEC is a reference basket consisting of 12 crudes, representing the main export crudes of the member countries weighted according to production and exports to the main markets.



Source: Food and Agricultural Organisation

3.3 *Inflation in Botswana decreased from 3.8 percent in December 2014 to 3.1 percent in June 2015, thus ending the six-month period within the Bank's objective range of 3 – 6 percent. Similarly, inflation excluding administered prices and the 16 percent trimmed mean inflation decreased from 4.9 percent and 3.7 percent to 4.7 percent and 3.6 percent, respectively, in the same period. The decrease in inflation across all the main measures reflected the impact of lower rates of price change for commodities with large weights in the consumer basket (e.g., food), modest wage growth[7], weak demand pressures and the subdued impact of the increase in administered prices[8] and government levies. Inflation breached the lower bound of the medium-term objective range in February and March, given the downward adjustment in fuel prices in February 2015, while the impact of extending the range of staple foods subject to a zero rate of value added tax also began to take effect. In addition, the appreciation of the Pula against the South African rand helped moderate imported inflation.*





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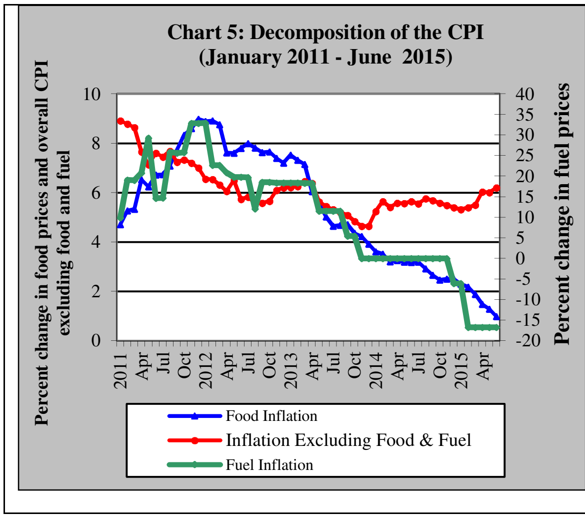
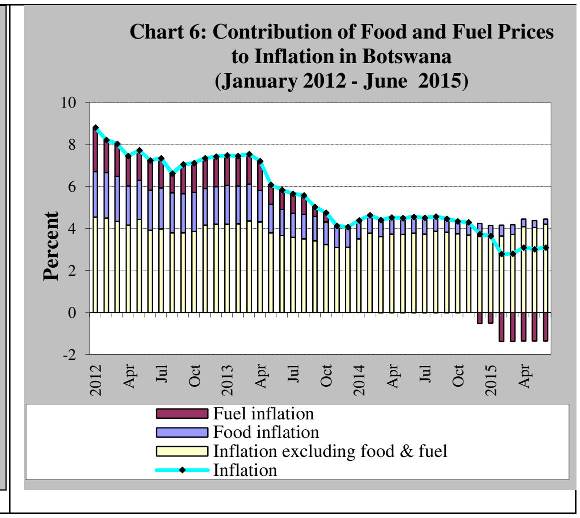
7 *Government increased civil service salaries by 6 percent in April 2015, which is in line with the Bank's upper band of the inflation objective range. This was considered modest due to the accumulated deterioration in the purchasing power over the years when the Government either did not award any salary increase or did so at a lower magnitude than the prevailing inflation.*

8 *On average, the adjustments in administered prices subtracted approximately 0.45 percentage points from inflation in the first half of 2015 compared to 0.12 percentage points added to inflation in the corresponding period in 2014.*





Source: Statistics Botswana and Bank of Botswana

3.4 *Demand pressures on inflation were modest in the first six months of 2015, in the main, due to restrained growth in personal incomes and commercial bank credit. The annual growth in commercial bank credit went down in the first half of the year, from 13.5 percent in December 2014 to 7.4 percent in June 2015. The credit growth occurred in the context of modest growth in incomes and stricter lending conditions applied by commercial banks*[9]*. Year-on-year growth in lending to the business sector decreased from 17.2 percent in December 2014 to 4.2 percent in June 2015, while that for household credit fell from 10.7 percent to 9.9 percent in the same period.*

3.5 *Growth in lending to households continues to be monitored for its potential impact on demand and financial stability. The current profile of household debt is consistent with maintenance of financial stability as reflected in the annual growth in mortgage loans to households, which declined from 18.4 percent in December 2014 to 6.9 percent in June 2015, while unsecured lending increased from 7.4 percent to 11.2 percent in the same period. The moderation of mortgage credit growth, against the backdrop of some weakening of prices in the property market, reduces potential risks in this area. Currently, banking sector indicators, including low default ratios for household borrowing, also*

[9] *Strict lending conditions augur well for financial stability, given the potential for reduced loan losses; however, safeguarding financial stability must be carefully balanced with the need for sufficient credit to support economic growth.*

suggest a stable financial environment. The aggregate ratio of non-performing loans to total loans was 2.9 percent in June 2015 (unchanged from December 2014).

3.6 Growth of domestic output is estimated at 4.6 percent in the year to March 2015; this is a significant decline from the annual growth of 7.9 percent in the first quarter of 2014. The lower growth is mainly attributed to a sharp deceleration in the expansion of the mining sector, which grew by 2.5 percent in the 12 months to March 2015 compared to 25.4 percent in the corresponding period last year. In the same period, growth in the non-mining sector increased marginally to 5 percent from 4.9 percent. The sectors that led non-mining output growth are trade, hotels and restaurants (7 percent), transport and communications (6.8 percent) and finance and business services (5.5 percent).

4. MONETARY POLICY IMPLEMENTATION IN THE FIRST HALF OF 2015

4.1 Globally, monetary policy in the first six months of 2015 was conducted in an environment of uneven growth prospects. Policymakers focused on measures such as liquidity support to the financial sector and structural reforms to nurture competitiveness and sustain growth momentum. In addition, there is continuing fiscal consolidation aimed at achieving sustainable budget deficits and reducing the current high levels of sovereign debt. Global inflation decreased due to lower oil and non-oil commodity prices, spare capacity in major economies, as well as subdued growth in global demand (especially in countries experiencing below-target inflation).

4.2 Monetary policy was accommodative in advanced economies, with the US Federal Reserve Bank, Bank of England, Bank of Japan, and European Central Bank (ECB)[10] maintaining policy interest rates at low levels, while the Reserve Bank of Australia reduced the policy rate by a cumulative 50 basis points, in the context of declining commodity prices that negatively impacted on its natural resource-based producers.

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10 The ECB began purchasing government bonds in March 2015, thus expanding its asset purchase programme by 60 billion euros per month until at least September 2016, in the context of the risk of deflation.

4.3 *In contrast, for emerging market economies, there were divergent policy actions to either support increased economic activity or restrain inflationary pressures stoked by currency depreciation. Policy interest rates were reduced in India and China, with the latter reducing the primary reserve requirements as well in an effort to stimulate growth. Conversely, in Brazil, monetary policy was tightened to restrain inflationary pressures in the first half of the year. Meanwhile, South Africa maintained the repo rate at 5.75 percent in the same period*[11].

4.4 *In Botswana, monetary policy was implemented against the background of moderate growth in nominal personal incomes and weak domestic demand pressures, thus restrained government expenditure and lower credit growth. Furthermore, foreign inflation was low, with benign pressure on domestic prices. These factors contributed to a positive medium-term outlook for inflation and provided scope for easing monetary policy to support economic activity without undermining price stability. Hence, the Bank Rate was reduced by 100 basis points in February 2015*[12].

4.5 *Monetary policy implementation involved the use of Bank of Botswana Certificates (BoBCs)*[13] *to absorb excess liquidity*[14] *in order to ensure maintenance of interest rates that are consistent with the monetary policy stance; while reverse repurchase agreements were used to mop up excess liquidity between weekly auctions of BoBCs. Earlier in the year, temporary liquidity shortfalls for individual financial institutions, which to some extent reflected inefficiency of the interbank market, continued to be addressed through recourse to the Bank's credit facilities. Furthermore, the Primary Reserve Requirement on Pula-denominated deposits was reduced from 10 percent to 5 percent effective April 1, 2015,*

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[11] *In late July 2015, the South African Reserve Bank increased the repo rate to 6 percent to influence inflation expectations downwards, given increased risks to the inflation outlook.*

[12] *The Bank Rate was reduced further by 50 basis points to 6 percent on August 6, 2015.*

[13] *The value of outstanding BoBCs exceeded the cap of P5 billion in the first half of 2015, in view of growth in commercial bank liabilities, in particular deposits by the Botswana Public Officers Pension Fund (BPOPF).*

[14] *Excess liquidity is money balances beyond that needed by commercial banks for investment and daily flows, with no credit extension obligation and hence can be invested temporarily. Importantly, each commercial bank holds a specific level of excess liquidity that reflects its management policy.*

thus injecting liquidity into the banking system. As at the end of June 2015, overall excess liquidity in the banking system was P9.3 billion.

4.6 *As a result of the reduction in the Bank Rate, money market interest rates decreased (Chart 7)[15]. The yield on the 14-day BoBC fell from 3.07 percent at the end of December 2014 to 1.87 percent in June 2015, while for the 3-month BoBC, the yield eased from 3.19 percent to 2.11 percent in the same period. The average prime lending rate of commercial banks also fell from 9 percent to 8 percent, while the 88-day deposit rate fell slightly from 2.67 percent in December 2014 to 2.62 percent in June 2015. Although the prime lending rate fell in response to policy easing, credit growth continued the downward trend as commercial banks adopted a cautious approach to lending in the context of reduced liquidity and increasing costs of raising loanable funds, particularly through customer deposits. Overall, there is a need for banks to review their asset, liability and risk management practices with a view to reflecting the changed situation and also actively consider possible alternative sources of financing in addition to deposits.*

4.7 *Generally, real interest rates decreased in the first half of the year from -0.70 percent in December 2014 to -1.19 percent in June 2015 for the 14-day BoBC and from -0.59 percent to -0.96 percent for the 3-month BoBC. Similarly, the real prime lending rate fell from 5.01 percent in December 2014 to 4.75 percent in June 2015.*

4.8 *In January 2015, the Pula basket weights for the South African rand and SDR were revised from 55 percent and 45 percent, respectively, to 50 percent each. Furthermore, the rate of crawl of the Pula exchange rate was changed from -0.16 percent to zero to reflect the minimal difference between the projected inflation in Botswana and the major trading partners, as represented by the composition of the Pula. The trade-weighted nominal exchange rate (NEER) was, therefore, stable in the six months to June 2015. Bilaterally, the Pula depreciated by 4 percent and 1.2 percent against the US dollar and SDR, respectively, while it appreciated by 1.6 percent against the rand. The real effective*

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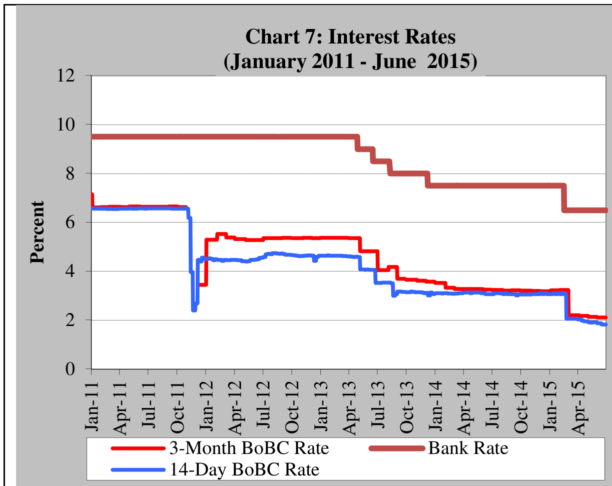
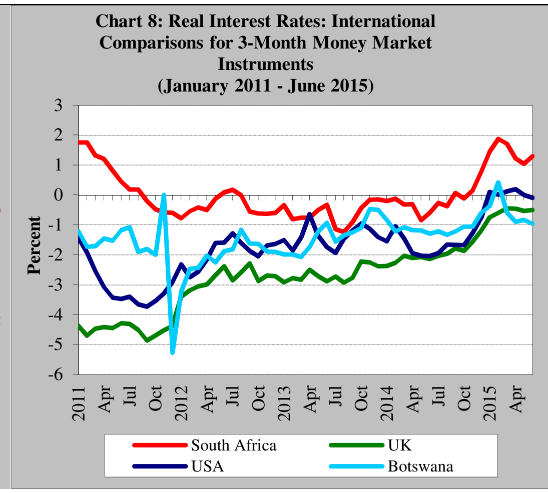
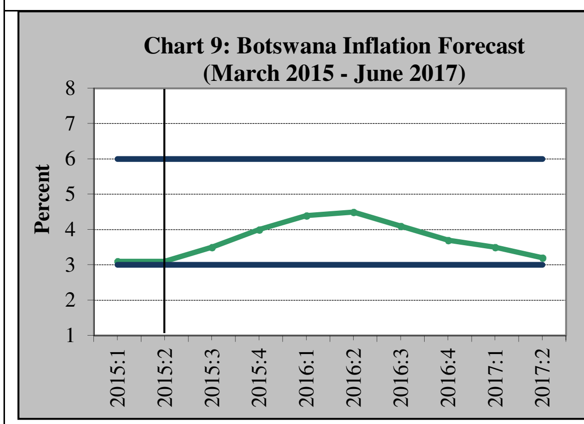
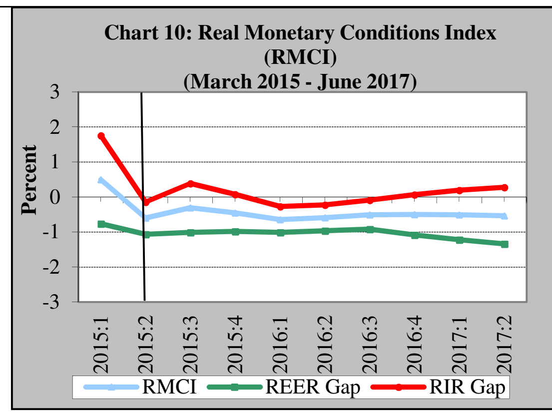
15 *Quoted yields are based on the weighted average of the winning bids at auction.*

exchange rate (REER)[16] of the Pula depreciated by 0.1 percent in the six months to June 2015 due to lower Botswana inflation compared to the average inflation of trading partner countries.









Source: Bank of Botswana.

4.9 *Developments with respect to the REER and real interest rates resulted in relatively loose real monetary conditions in the first half of 2015. The moderately loose monetary conditions reflected the dominance of the real exchange rate gap relative to the real interest rate gap.*

5. *MEDIUM-TERM INFLATION OUTLOOK*

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

5.1 *The forecasting process for inflation entails an assessment of likely changes in factors that affect domestic price movements; namely, demand and supply interaction, 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.*[17]

5.2 *Global output in 2015 is forecast to increase by 3.3 percent, which is slightly lower than 3.4 percent of 2014. Output growth for major economies is projected at 2.1 percent in 2015, from 1.8 percent in 2014. In emerging market and developing economies, growth is expected to slow from 4.6 percent in 2014 to 4.2 percent in 2015. This would be reflective of tighter external financial conditions as well as weaker economic expansion in China and the decline in commodity prices, which could weigh down on growth momentum in commodity-exporting countries. Furthermore, the expected commencement of a monetary policy tightening cycle in the USA and UK could lead to currency depreciation in emerging market economies, higher borrowing costs and consequently higher inflation. In South Africa, GDP is forecast to grow by 2 percent in 2015 compared to 1.5 percent in 2014, but economic prospects continue to be hindered by the persistent electricity supply shortages.*

5.3 *Globally, inflationary pressures are expected to be dampened by weaker growth in global economic activity, low commodity prices and spare capacity in advanced economies. Therefore, global inflation is projected to decline from 3.5 percent in 2014 to 3.2 percent in 2015. Overall, it is expected that external price developments will have a benign influence on domestic inflation. In particular, inflation for trading partner countries is projected to average 2.3 percent in 2015, mostly reflecting persistently low inflation in SDR countries (0.17 percent). Headline inflation in South Africa is forecast to average 4.5 percent and remain within the 3 – 6 percent target range until the end of 2015. It is expected*

[17] *Forecasts for external variables are obtained mainly from the IMF's WEO database.*

that the relative strength of the Pula against the South African rand will moderate imported inflation.

5.4 *Domestic non-mining output expansion is projected to remain above trend in the medium term; however, domestic demand pressures on inflation are expected to be modest, given restrained growth in personal incomes. Slower growth in credit also contributes to modest demand pressure on inflation. Overall, it is expected that inflation will be within the objective range for the remainder of 2015 and into the medium term.*[18] *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 as well as technological progress, productivity improvements, structural reforms and growing trade and competition.*

5.5 *It is projected that monetary conditions will ease going forward, in view of the dominance of the negative real effective exchange rate gap over the mostly positive real interest rate gap. The unrestrictive real monetary conditions are expected to contribute to growth in economic activity in the medium term.*

6. MONETARY POLICY STANCE

6.1 *The current state of the economy and the projected performance as well as the level of the financial sector development, along with the positive inflation outlook, suggest that maintaining an accommodative monetary policy stance is consistent with keeping inflation within the 3 – 6 percent objective range in the medium term.*

6.2 *The Bank's implementation of the exchange rate policy will entail a zero rate of crawl for the NEER, given that inflation in Botswana is projected to be close to the lower bound of the medium-term objective range of 3 – 6 percent.*

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[18] *As reported in the March 2015 Business Expectations Survey, businesses expect inflation to remain within the objective range for both 2015 and 2016.*

7. SUMMARY AND CONCLUSION

7.1 Inflation remained within the Bank's objective range of 3 – 6 percent for most of the first six months of 2015 against the background of benign domestic demand pressures, modest wage growth and the subdued impact of the increase in administered prices and government levies, and favourable foreign price developments. The Bank Rate was reduced by a percentage point in the first half of 2015 to bolster economic growth in the context of the positive medium-term outlook for price developments, while the primary reserve requirement was reduced to ameliorate tight liquidity in the banking system.

7.2 Looking ahead, it is anticipated that external price pressures on domestic inflation will be benign, given the projected moderate expansion in global economic activity, low commodity prices and the dampening impact of the capacity underutilisation in major economies. In the domestic economy, the slow increase in incomes and credit as well as restrained government expenditure are expected to moderate demand pressures. Consequently, maintaining an accommodative monetary policy stance is consistent with achieving the inflation objective in the medium term and remains appropriate for stimulating stronger economic expansion. The Bank remains committed to monitoring economic and financial developments with a view to responding appropriately to ensure price and financial stability, without undermining growth in economic activity.