MID-TERM REVIEW OF THE
2016 MONETARY POLICY STATEMENT

1. INTRODUCTION

1.1 The Mid-Term Review (MTR) of the 2016 Monetary Policy Statement (MPS) examines price developments and the underlying causal factors in the first half of 2016. It also assesses key financial and economic developments that are likely to impact on the inflation outlook and financial stability in order to evaluate the likely monetary policy choices for the second half of 2016. The review assists the Bank to promote policy credibility and understanding of monetary policy by 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 projected in the 2016 MPS launched in February, inflation remained low and stable in the first six months of 2016. Inflation declined from 3.1 percent in December 2015 to 2.7 percent in June 2016[1], remaining at or below the lower end of the objective range throughout the period. Price developments were indicative of low domestic demand pressures due, in part, to the restrained growth in personal incomes and subdued foreign inflation in the context of sluggish global economic activity and the resultant weaker commodity prices. On account of the positive medium-term outlook for inflation, the Bank Rate was maintained at 6 percent for the first half of 2016.

1.3 At the time of the MPS launch, global economic growth for 2016 was forecast at 3.4 percent[2], thus reflecting a sustained pace of weak to modest growth in both advanced and emerging market economies. Due to lower-than-expected growth early in the year and persistent uncertainty, particularly in advanced economies, the forecast of global economic growth was revised downwards in July 2016 to 3.1 percent and 3.4 percent for 2016 and 2017, respectively[3]. In particular, economic activity is expected to remain weak in advanced countries, while growth prospects remain diverse for emerging market and developing economies (EMDEs).

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 a conducive financial environment foster savings mobilisation, productive investment and international competitiveness of domestic producers which, in turn, contribute towards the broader national objective 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 account of prospects for economic growth and developments relating to stability of the

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[1] Inflation was 2.7 percent in July 2016.

[2] The International Monetary Fund's World Economic Outlook (WEO) Update, January 2016.

[3] International Monetary Fund, WEO Update, July 2016. Part of the uncertainty relates to prospects for a negative outcome of the vote by the United Kingdom to leave the European Union (Brexit). The appendix presents further analysis of the anticipated impact of Brexit.

financial system. To this end, in assessing the policy stance, the Bank factors in projections of real monetary conditions[4] in the context of other relevant domestic and international economic and financial developments, and their impact on the output gap[5] and, ultimately, inflation. The policy framework also recognises the importance of communication with stakeholders in order to influence expectations. Accordingly, the Bank issues a press release after each meeting of the Monetary Policy Committee (MPC) to announce policy decisions and their rationale.

3. ECONOMIC DEVELOPMENTS IN THE FIRST HALF OF 2016

(a) External Developments

3.1 In the first half of 2016, monetary policy was conducted in an environment of subdued global economic activity and uncertain prospects. Policymakers generally focused on achieving sustainable growth through accommodative monetary policy (including low interest rates and liquidity support to the financial sector) and structural reforms to foster competitiveness in the long term. Accommodative monetary policy was predominant in advanced countries while monetary policy responses were divergent in emerging market economies, reflecting, in some instances, the need to support growth and in others to contain inflationary pressures. Meanwhile, uncertainty in global financial markets associated with the United Kingdom's vote to leave the EU is likely to result in monetary policy remaining accommodative for longer[6].

3.2 Global inflation was restrained in the first half of the year, mainly reflecting low commodity (including oil) prices, modest global demand and persistent spare capacity in major economies. Nonetheless, there has been notable upward pressure on inflation in some EMDEs due to the inflationary impact of currency depreciation on import prices. For Botswana's trading partner countries[7], average inflation increased from 2.8 percent in December 2015 to 3.4 percent in June 2016. In particular, for the same period, South African inflation breached the upper end of the South African Reserve Bank's target range of 3 – 6 percent (moving from 5.2 percent to 6.3 percent), while for SDR countries, inflation increased slightly from 0.4 percent to 0.5 percent in the same period.[8]

3.3 Oil prices recovered from an average low of USD30 per barrel in January to around USD45 per barrel at the end of June 2016 (Chart 1), against the background of a reduction in shale oil production in North America, supply disruptions in some major oil-producing countries and an increase in demand in India and other Asian countries. International food prices also increased, by 6.5 percent, in the six months to June 2016 (Chart 2), reflecting the increase in costs for all constituent food categories (meat,

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[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.

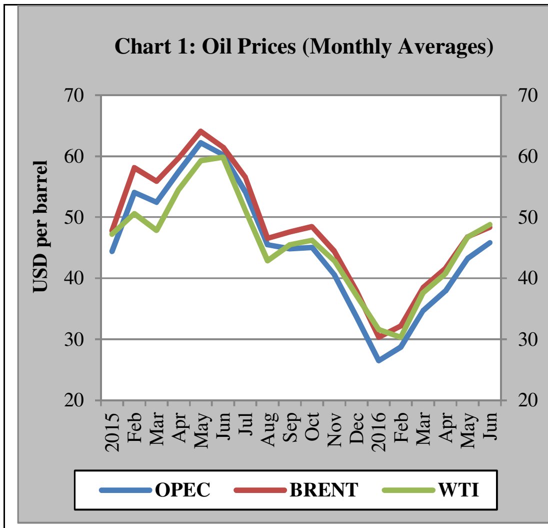
[5] The output gap refers to the difference between actual output and long-term trend output (as an indicator of productive capacity). A negative output gap means the actual level of output for a given period is below the trend level for that period, thus indicating the economy is operating below its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

[6] For example, the Bank of England (BOE) has pointed out that the outlook for economic growth in the short to medium term has weakened significantly as a result of the Brexit vote. Consequently, monetary policy was eased in August 2016 to support economic activity. In particular, the BOE cut the Bank Rate by 25 basis points to 0.25 percent, while the stock of asset purchases was increased by £60 billion to £435 billion.

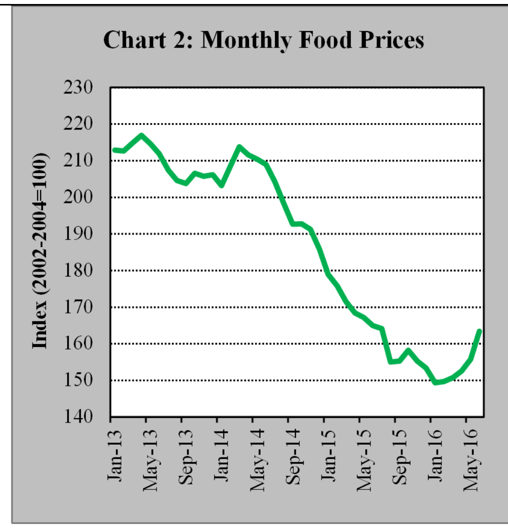
[7] South Africa and the SDR countries (euro area, Japan, UK and USA).

[8] Inflation remains very low in SDR countries, with Japan and the euro area reporting negative rates in the first half of 2016.

cereals, sugar, oils, and dairy products). Overall, international oil and food prices remained relatively low and did not pose any significant risk to the inflation outlook in the first half of 2016.



Source: OPEC and US Energy Information Administration



Source: Food and Agricultural Organisation

(b) Output and Price Developments in Botswana

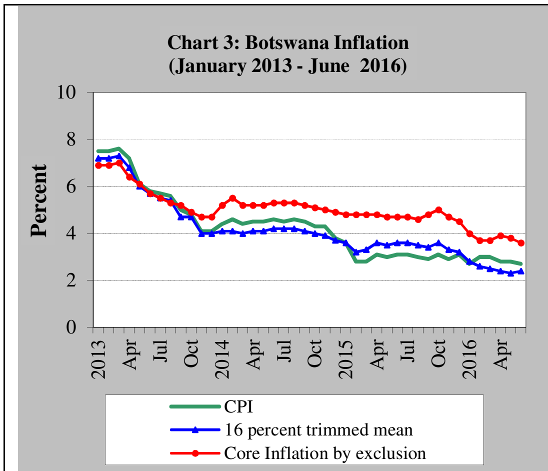
3.4 *Real GDP contracted by 0.2 percent in the twelve months to March 2016 compared to the revised annual growth of 3.2 percent for the corresponding period ending in 2015. The weaker performance reflects the significant contraction of 21.4 percent in the mining sector in the year to March 2016 compared to a decline of 0.1 percent the previous year. In the same period, growth in the non-mining sector decreased marginally from 3.9 percent to 3.8 percent. The sectors that led non-mining output growth were trade, hotels and restaurants (6.4 percent), transport and communications (5.4 percent) and finance and business services (4.5 percent).*

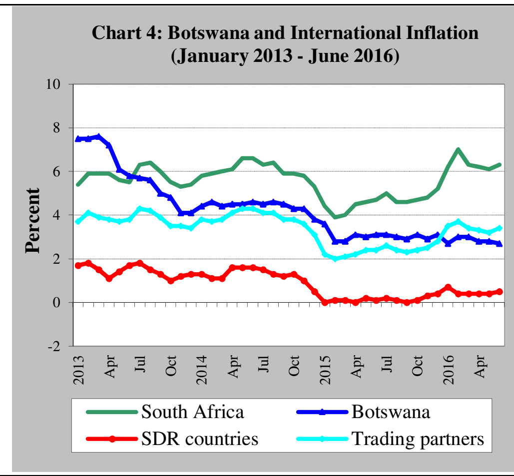
3.5 *The subdued economic activity, alongside slow growth in personal incomes[9] (and the associated weak demand pressures) and the moderating impact of the net decrease in administered prices and government levies (due to the decrease in fuel prices), resulted in benign inflationary pressures in the first half of 2016. External pressures on domestic prices were also restrained against the backdrop of low inflation among trading partner countries and an appreciation of the rand/Pula exchange rate. Therefore, domestic inflation was stable around the lower end of the Bank's medium-term objective range in the first half of 2016.*

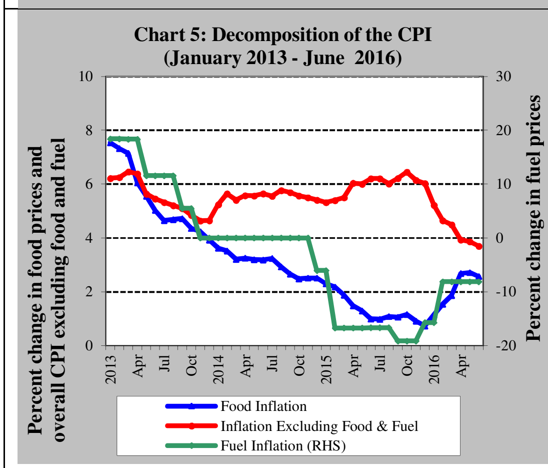
3.6 *Inflation in Botswana decreased from 3.1 percent in December 2015 to 2.7 percent in June 2016 and was below the lower end of the Bank's objective range of 3 – 6 percent (Chart 3). In particular, fuel prices fell by 8.1 percent in the twelve months to June 2016, following a 15.7 percent decrease in 2015, while food inflation increased from 0.7 percent to 2.6 percent in the same period (Charts 5 and 6). On average, the net effect of adjustments of administered prices in the first half of 2016 was a reduction in inflation by approximately 0.22 percentage points compared to a reduction of 0.45 percentage*

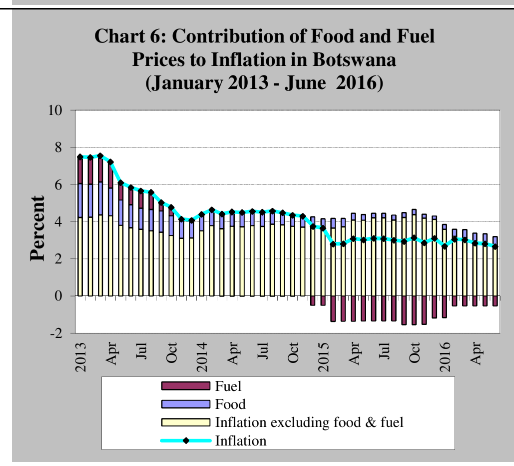
[9] *Government increased civil service salaries by 3 percent in April 2016, which equals the Bank's lower end of the inflation objective range.*

points in June 2015. Inflation excluding administered prices and the 16 percent trimmed mean inflation decreased from 4.5 percent and 3.2 percent in December 2015 to 3.6 percent and 2.4 percent in June 2016.









Source: Statistics Botswana and Bank of Botswana

(c) Government Expenditure, Credit Developments and Financial Stability Indicators

3.7 *Total government expenditure for the 2015/16 fiscal year grew by 2.8 percent compared to the 2016 Budget Speech projection of a 10.6 percent increase. Recurrent spending increased by 4.5 percent (11 percent projected), while development spending contracted by 2.3 percent (9.5 percent projected growth). However, due to the lower-than-projected revenue outturn (particularly mineral revenue), the estimated budget deficit was P6.6 billion or 4.5 percent of GDP, larger than the initial projection of P4.2 billion. Meanwhile, in the twelve months to June 2016, total government spending is estimated to have increased by 9.2 percent. Development and recurrent expenditure increased by 20.8 percent and 5.5 percent, respectively, in the same period.*

3.8 *Against the background of an accommodative monetary policy stance and despite the weaker economic activity and restrained growth in personal incomes, the annual growth in commercial bank credit increased in the first half of the year, from 7.1 percent in December 2015 to 10.1 percent in June 2016. The increase in annual credit growth reflects the increase in lending to businesses. Year-on-year growth in lending to the business sector increased from a contraction of 0.3 percent in December 2015 to 7.4 percent in June 2016, while for households, annual growth in credit fell marginally from 12.8 percent to 12 percent in the same period.*

3.9 *Banking system indicators, including low default ratios, suggest a stable financial environment. The aggregate ratio of non-performing loans to total loans increased from 3.3 percent in December 2015 to 4.2 percent in June 2016.*[10] *Sectorally, the ratio of non-performing loans to total loans increased from 3.4 percent in December 2015 to 4.4 percent for businesses and from 3.2 percent to 4.1 percent for households in the same period. The allocation of credit is diversified across sectors and economic activity, while the increase in lending is in the context of projected positive non-mining GDP growth. Moreover, unsecured household lending, which constitutes a large proportion of commercial bank credit, represents relatively small/moderate amounts spread across many borrowers of differing profiles. Growth in mortgages has moderated in line with broader economic prospects. Overall, current levels of credit growth continue to be supportive of economic activity and augur well for durable stability of the financial system.*

4. Monetary Policy Implementation in Botswana in the First Half of 2016

4.1 *Domestic monetary policy was implemented in the context of below-trend economic growth (a non-inflationary output gap) and a positive medium-term outlook for inflation. Inflation was restrained due to slow growth in personal incomes, moderate increase in credit and the resultant subdued domestic demand. Furthermore, foreign inflation was low on average, with benign pressure on domestic prices; hence the Bank Rate was maintained at 6 percent for the first half of the year.*[11] *The current level of interest rates is considered appropriate to support economic activity, growth in deposits and financial development.*

4.2 *Monetary policy implementation entailed the use of Bank of Botswana Certificates (BoBCs) to absorb excess liquidity 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. In order to promote productive deployment of funds and market efficiency, as well as moderate the cost of liquidity absorption, the Bank conducted monetary operations with a view to capping BoBCs issuance at P5 billion. Despite the cap, the value of outstanding BoBCs was P7.5 billion in June 2016, down from P8.2 billion in December 2015.*[12]

4.3 *As a result of competitive bidding for BoBCs by market participants, money market interest rates decreased in the review period (Chart 7)*[13]*. The yield on the 14-day BoBC fell from 0.97 percent at the end of December 2015 to 0.84 percent at the end of June 2016, while for the 3-month BoBC, the yield eased from 1.17 percent to 1.09 percent in the same period. The 88-day deposit rate fell from 2.5 percent in December 2015 to 2.16 percent in June 2016, while the average prime lending rate of commercial banks was constant at 7.5 percent in the same period. The real 3-month BoBC yield increased from -1.87 percent to -1.57 percent, reflecting the smaller decrease in the nominal interest rate compared to that of inflation between December 2015 and June 2016. Similarly, the real prime lending rate increased from 4.27 percent in December 2015 to 4.67 percent in June 2016.*

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[10] *For individual banks, the ratio of non-performing loans to total loans ranged from zero to 8.4 percent in December 2015, while the range was 1.3 percent to 9.1 percent in June 2016.*

[11] *The Bank Rate was reduced by 50 basis points to 5.5 percent in August 2016.*

[12] *Achieving the cap on BoBCs has been elusive due, in part, to increased excess liquidity resulting from growth in deposits at commercial banks, notably placement by the Botswana Public Officers Pension Fund, and expansion in government spending, including through lending to parastatals.*

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

4.4 *In January 2016, the weights in the Pula basket for the South African rand and SDR were maintained at 50 percent each. At the same time, the rate of crawl of the Pula exchange rate was changed from zero to the 0.38 percent upward rate of crawl, given that inflation was projected to be around the lower end of the medium-term objective range of 3 – 6 percent and, therefore, lower than the expected average trading partner countries. The trade-weighted nominal effective exchange rate (NEER) was virtually stable (0.2 percent appreciation) in the six months to June 2016 in the context of a transition from the zero rate of crawl in 2015 to the 0.38 percent upward rate of crawl from January 2016. In the same period, bilateral exchange rates were such that the Pula weakened by 1.6 percent against the rand, while it strengthened by 2.7 percent and 2 percent against the US dollar and SDR, respectively. The real effective exchange rate (REER)[14] of the Pula depreciated by 1 percent in the six months to June 2016 due to Botswana inflation being lower than the average inflation of trading partner countries.*

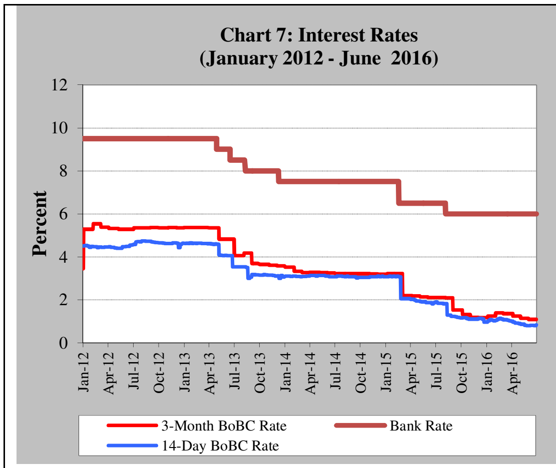

Chart 7: Interest Rates (January 2012 - June 2016)

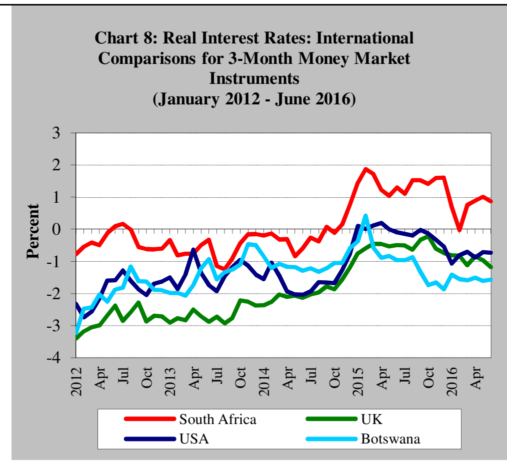

Chart 8: Real Interest Rates: International Comparisons for 3-Month Money Market Instruments (January 2012 - June 2016)

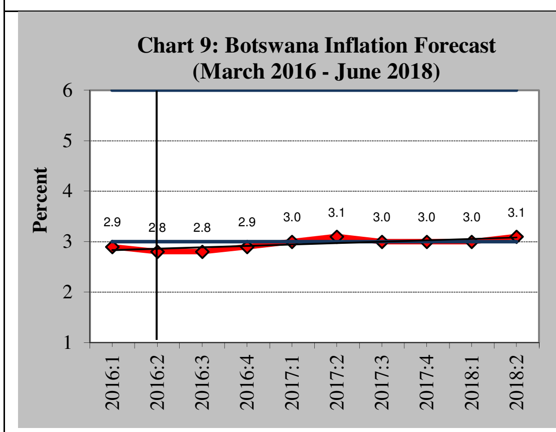

Chart 9: Botswana Inflation Forecast (March 2016 - June 2018)

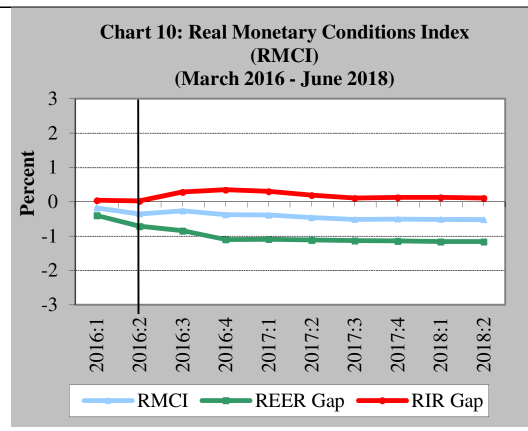

Chart 10: Real Monetary Conditions Index (RMCI) (March 2016 - June 2018)

Source: Bank of Botswana.

Notes: 1. The REER Gap is a measure of the deviation of the REER from its trend value.

2. The Real Interest Rate (RIR) Gap is a measure of the deviation of the real interest rate (i.e., 3-month real BoBC rate) from its trend value.

3. RMCI is a weighted sum of the REER gap and RIR gap.

4.5 *Developments with respect to the REER and real interest rates resulted in easing of real monetary conditions in the first half of 2016 due to the dominance of the REER gap over*

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

the RIP gap. The mildly accommodative real monetary conditions are expected to contribute to the recovery in economic activity in the medium term.

5. *MEDIUM-TERM INFLATION OUTLOOK*

5.1 *The inflation forecasting process 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, especially changes in international commodity prices and demand in major markets.*[15]

5.2 *Global output in 2016 is forecast to increase by 3.1 percent, as was the case in 2015, while output growth for major economies is projected at 1.8 percent in 2016, slightly lower than the 1.9 percent in 2015.*[16] *In EMDEs, growth is expected to increase slightly from 4 percent in 2015 to 4.1 percent in 2016, against the background of modest global demand and subdued commodity prices. In South Africa, GDP is forecast to grow by 0.1 percent in 2016 compared to 1.3 percent in 2015, as economic prospects continue to be constrained by low commodity prices, drought, industrial disputes and uncertainty with respect to government policy.*

5.3 *Inflationary pressures are expected to be restrained by subdued growth in global economic activity, low commodity prices and spare capacity in advanced economies. Therefore, global inflation is projected at 2.8 percent in 2016, which was the same level for 2015. Overall, it is expected that foreign price developments will have a benign influence on domestic inflation. In particular, inflation for trading partner countries is anticipated to average 3.7 percent in 2016, mostly reflecting persistently high inflation in South Africa. Headline inflation in South Africa is forecast to average 6.6 percent and remain above the upper end of the 3 – 6 percent target range for the rest of 2016. Nonetheless, it is envisaged 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 below trend in the medium term, influenced mainly by continuing uncertainty relating to the supply of electricity and water, poor performance of the agricultural sector due to extended drought, slow recovery of the mining sector and restrained economic growth in major trading partners. However, gradual recovery is expected in the medium term in response to the projected loose monetary conditions. Overall, inflation is forecast to fluctuate around the lower end of the objective range of 3 - 6 percent in the medium term.*[17] *Upside risks to the inflation outlook relate to any considerable upward adjustment in administered prices and government levies and any increase in international oil prices beyond current forecasts, as well as any significant upward deviation in regional food prices from international trends. However, there are downside risks associated with restrained global economic activity and the potential fall in commodity prices.*

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 positive real interest rate gap,*

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

[16] *The July WEO Update revised downwards the forecast of global and advanced economies' growth rates for 2016 from 3.2 percent and 1.9 percent, respectively.*

[17] *As reported in the March 2016 Business Expectations Survey, businesses expect inflation to remain within the objective range in 2016 and 2017.*

contributing to recovery and growth in economic activity in the medium term. Even then, structural constraints, disruptions to supply of inputs and utilities (for example, electricity and water) as well as external and weather shocks could still have an adverse impact on growth.

6. MONETARY POLICY STANCE IN THE SECOND HALF OF 2016 AND MEDIUM TERM

6.1 The current state of the economy and the projected performance, as well as the level of 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. Consistent with this assessment, the Bank Rate was reduced to 5.5 percent in August 2016.

6.2 The Bank's implementation of the exchange rate policy will continue to entail a 0.38 percent upward rate of crawl for the NEER for the remainder of 2016, given that inflation in Botswana is projected to be close to the lower end of the medium-term objective range of 3 – 6 percent and below the projected average inflation of trading partner countries.

7. SUMMARY AND CONCLUSION

7.1 Inflation fluctuated around the lower end of the Bank's objective range of 3 – 6 percent in the first six months of 2016 against the background of benign domestic demand pressures, modest wage growth and the subdued impact of the increase in administered prices and government levies as well as favourable foreign price developments. Consequently, the Bank considered that maintenance of an accommodative monetary policy was consistent with achieving the inflation objective in the medium term and appropriate for stimulating economic growth.

7.2 Looking ahead, inflation is forecast to remain low and stable in the medium term in line with the Bank's objective range. The Bank's formulation and implementation of monetary policy will focus on entrenching expectations of low and sustainable inflation, through timely responses to price developments, while ensuring that credit and other market developments are consistent with the maintenance of financial stability. 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.

Potential Impact of the "Brexit" on the Global Economy

The decision by the UK to leave the European Union, the so-called Brexit, has added uncertainty to an already fragile global economic recovery. Notably, global growth prospects have been revised downwards since the outcome of the referendum. The volatility that ensued in the global financial markets has since declined, although confidence remains a concern for policymakers. Currently, the impact of Brexit cannot be quantified, not least because the formal negotiations on the terms of withdrawal are not expected to begin until 2017. However, the uncertainty it has created (mitigated in part by the rapid formation of a new UK Government) is expected to weigh down on consumer and business confidence, which, in turn, will result in reduced consumption and investment. This will be more pronounced for the UK and EU as investment decisions will be delayed during the transitional period. In order to shore up confidence, the Bank of England has already announced a package of measures to loosen monetary policy further, including through lower interest rates and a resumption of quantitative easing.

Brexit is anticipated to have an effect on UK's trade. The weaker pound sterling is expected to result in a fall in UK's imports from European trading partners, in particular decline in exports for those where the UK is a major market. However, by the same token, exports from the UK, including services such as tourism, are likely to benefit from a weaker pound. Exports of the two largest economies, USA and China, are less vulnerable to the UK and a weaker pound. As a result, the negative impact of Brexit on global trade should be minor. The trade impact of Brexit on Emerging Market and Developing Economies (EMDEs) remains unclear. As investors seek higher yields, given the prospects for continuation of accommodative monetary policy in the UK and the US, there has been an increase in capital flows to emerging market economies.

The impact of Brexit on China and the USA (Botswana's key markets for diamonds) appears negligible, thus it should not have a pronounced effect on the Botswana economy. For Botswana's beef exports to EU, the impact, if any, could materialise after conclusion of trade agreements between the UK and the EU, as there are no indications demand would change as a result of the UK leaving the EU. Agreements could take at least two years to conclude, which could allow the Botswana Meat Commission enough time to identify new markets that could take up the slack should exports to the EU and UK decline.

The potential impact of Brexit on the domestic economy remains a subject of interest to the Bank.