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## NOTE TO EDITORS

### THE PULA EXCHANGE RATE FRAMEWORK EXPLAINED

These are additional notes to the Press Release on Pula Exchange Rate, of December 22, 2022, issued by the Ministry of Finance.

#### Definition of Exchange Rate

The exchange rate of a currency is how much one currency can be bought for each unit of another currency or, put differently, the rate at which domestic currency can be converted into a foreign currency or vice versa.

#### Exchange Rate Policy Frameworks

The exchange rate policy framework refers to the manner in which a country manages its own currency in relation to foreign currencies and the foreign exchange market.

Exchange rate policy frameworks range from flexible to fixed and variations in between. In a flexible exchange rate framework, the exchange rate is freely determined by the market on the basis of demand and sentiments about the economy. In a fixed exchange rate regime, the domestic currency is linked to another currency or a basket (combination) of other currencies. In between flexible and fixed exchange rates, there is a range of, usually managed, exchange rate frameworks, such as a crawling band or peg.

#### Botswana's Exchange Rate Policy Framework

Since 2005, Botswana adopted and implemented a crawling peg exchange rate policy framework that has **three** key attributes.

**First**, the Pula is fixed to a basket of foreign currencies, namely the Special Drawing Rights (SDR) and the South African rand. The SDR comprises the US dollar, British pound, euro, Japanese yen and Chinese renminbi.

**Second**, is the weight of these currencies in the Pula basket (proportions that each of these currencies contribute to the value of the Pula). Currently, the Pula exchange rate is constituted by 55 percent SDR and 45 percent South African rand.

**Third**, is the annual rate of crawl, which is the amount (rate) at which the exchange rate is allowed to gradually depreciate or appreciate. This amount reflects the inflation differential between Botswana and its trading partner countries. For example, 1.51 percent downward crawl for 2023; from the downward rate of crawl of 2.87 percent from May 2020 – December 2022.

### Botswana's Exchange Rate Policy Objective

The policy objective is to maintain price competitiveness of local producers for similar products, in both the domestic and international markets by equalising the exchange rate-adjusted prices. In general, this is done through adjusting the nominal Pula exchange rate by an amount that is equal to the differences in inflation between Botswana and the trading partner countries. That is, **the rate of crawl**.

For example, if a bag of potatoes is currently P100 in Botswana and R130 in South Africa at an exchange rate of P1 = R1.30, and assuming transport costs are not embedded in the pricing, Botswana's producers face similar market price as South African producers and, therefore, competitive. If, however, inflation in Botswana rises to be 5 percentage points higher than in South Africa, Botswana producers will be disadvantaged as it would be cheaper to purchase the same bag of potatoes in South Africa, holding all other things constant. Therefore, the Pula exchange rate needs to adjust downward by 5 percent (**rate of crawl**) to maintain competitiveness of producers in Botswana; technically, maintenance of a stable real effective exchange rate (REER).

The exchange rate and competitiveness have also to relate to countries that Botswana trades with, in terms of goods and services, but also the flow of investments. It has been determined that these are mostly South Africa and the SDR countries (the USA, UK, euro area, China and Japan). This explains the fixing of the Pula to currencies of these countries. The 45 percent South African rand and 55 percent SDR proportions are based on observed historical trade pattern and are also subject to annual review. In addition, the fixing to a basket rather than a single currency helps to moderate volatility of the Pula against any single currency. This explains why during the times when the South African rand and other currencies are volatile, the Pula remains relatively stable.

### 2023 Pula Exchange Rate Parameters

In the context of Botswana's crawling band exchange rate arrangement for the Pula, the Ministry of Finance in conjunction with the Bank of Botswana, reviews the parameters for the Pula exchange rate twice in a year; being the currencies in the Pula basket and their weights, as well as the rate of crawl. This is done to assess alignment of the Pula exchange rate with the policy objective of maintaining a stable and competitive real effective exchange rate of the Pula; that is, retaining competitiveness of Botswana producers against imports and exports in international markets.

For 2023, it was determined that inflation in Botswana would be on average 1.51 percent higher than in the trading partner countries and, therefore, a 1.51 percent annual downward crawl would be implemented through small daily adjustments that would equal 1.51 percent over twelve months. It was also determined that the trade patterns remain largely unchanged and, therefore, maintained at 55 percent SDR and 45 percent South African rand.

### The Benefits of the Crawling Band Framework for Botswana

The benefits of the current crawling band framework are therefore as follows:

- (a) it affords flexibility for adjustments to address deterioration in international price competitiveness of the domestic industry;
- (b) any adjustment is gradual and, therefore, not disruptive nor destabilising;
- (c) the rate of adjustment is preannounced and retained for a year and, therefore, enables planning for economic decisions;
- (d) the framework is broadly in alignment with the price stability objective (inflation objective inherent in the monetary policy framework);
- (e) and the basket composition moderates fluctuations of the Pula exchange rate against any individual currency.

In contrast, alternative arrangements could have disadvantages as follows:

- (a) With a small undiversified economy such as Botswana with irregular and lumpy foreign exchange flows, a floating exchange rate regime would imply large exchange rate fluctuations that could be debilitating to price determination and economic activity. In addition, there could be sustained movement of the exchange rate, especially appreciation, that can undermine competitiveness of the non-mining sector and, therefore, diversification efforts;
- (b) as demonstrated in the past a fixed hard peg would often require adjustments that are large and discrete with a destabilising disruptive impact. For example, a large devaluation with significant inflationary impact; and
- (c) a peg to a single currency would imply the Pula being subject to fluctuations and shocks to the currency to which it is pegged and, in turn, policy responses that may be inimical or inconsistent with the needs of the domestic economy at the time.

### Limits of Exchange Rate Adjustments on Industry Competitiveness

While there are short-term benefits of deliberate exchange rate adjustments to maintain price competitiveness, for it to have the desired long-term impact there should be adequate production capacity and productivity improvements by the domestic industry. In addition, for government institutions, there should be effective implementation of plans and programmes. Overall, therefore, there is need for

generalised entrenchment and traction of structural transformation and policy reforms as being fundamental to industrialisation and productivity improvements that would enhance competitiveness of domestic producers in a low inflation environment.

It is recognised that, in the main, sustained (need for) downward adjustment of the currency is a reflection of weak production capacity and productivity of the economy; and is also inflationary (ultimately affecting price competitiveness).

#### Transparency and Market Information

The announcements of the Pula exchange rate parameters and any adjustments are intended to enhance transparency and integrity of the framework. In this regard, knowledge of the Pula basket weights, and rate of crawl enable the market and the general public to plan for investments and transactions on the basis of publicly available information that can be used as an input to any economic decisions.

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