MONETARY POLICY STATEMENT – 2007

1. INTRODUCTION

1.1 The purpose of the 2007 Monetary Policy Statement (MPS) is to review inflation trends in the last year and the extent to which the Bank succeeded in meeting the inflation objective set for 2006. The MPS also examines prospective economic and financial factors that are likely to affect the inflation outlook, and highlights the inflation objective for the year, as well as the expected policy reactions to achieve it. Through the MPS, the Bank fulfils its obligation to inform all stakeholders about the prospective policy response that will ensue in the months ahead in order to achieve the inflation objective and, in the process, encourage appropriate pricing behaviour, and saving and/or expenditure decisions for the rest of the year. Furthermore, the MPS reaffirms that the inflation objective set for the year is part of the gradual move towards the achievement of the medium-term 3 - 6 percent desired range during 2008.

1.2 Inflation rose at the beginning of 2006, from 11.4 percent at the end of 2005 to a peak of 14.2 percent in April 2006; thereafter it declined steadily to 8.5 percent in December[1], mainly due to the dissipation of the inflationary effect of the May 2005 devaluation of the Pula. Nevertheless, the end–year inflation still exceeded the 4 - 7 percent range desired for 2006. The reasons for the initial upward trend in the rate of price increases include the re-introduction of fees in government secondary schools and a large increase in the price of meat products.

1.3 Domestic demand pressures were moderate during 2006, mainly due to the unexpectedly slow growth in government expenditure, which offset the impact of strong growth in commercial bank credit to the private sector. Globally, oil prices, which increased significantly in the first half of 2006, were a major risk to inflation. Their impact on general prices was, however, mitigated by pre-emptive policy tightening and an increase in productivity in several major economies.

1.4 This year, inflation is expected to continue to subside. International oil prices are likely to continue to decline, while the increase in domestic expenditure should continue to be largely restrained by a restrictive monetary policy. Overall, therefore, it is expected that inflation will stabilise at around 7 percent from the second quarter to the end of 2007.

2. MONETARY POLICY FRAMEWORK AND OBJECTIVES

2.1 The objective of the Bank's monetary policy is to achieve a sustainable, low and predictable level of inflation. This goal contributes towards broader national

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[1] *The base year for the Consumer Price Index (CPI) was shifted forward from November 1996 (equals 100) to September 2006 (equals 100). In addition, the formula for deriving the CPI was changed from the arithmetic average to geometric average and the coverage of items in the new CPI basket was enlarged. The overall effect of the changes made is a more accurate assessment of inflation trends.*

objectives of sustainable economic growth and development, since a low and predictable inflation positively affects savings and investment decisions in addition to other socio-economic benefits.

2.2 *The monetary policy framework and its formulation takes account of the transmission process of policy changes, which has a lagged effect on the ultimate objective, as well as the need for a measured response to inflation developments that is not costly in terms of employment and output growth. It is against this background that monetary policy is formulated and implemented in the context of a medium-term horizon of three years.*

2.3 *In order to control inflation, the Bank adjusts interest rates, which, in turn, affect credit, as a major source of financing expenditure. Changes in interest rates, together with exchange rate, trade and fiscal policies, influence the overall spending on goods and services in the economy in a given period.*

2.4 *The overall thrust of monetary policy is threefold. First, it is to manage the rate of increase in overall expenditure, through the impact of interest rates on credit, in relation to the available supply of goods and services. Second, it is to influence investment decisions through changes in the cost of borrowing. Third, the success with which monetary policy achieves the Bank's inflation objective anchors price expectations of all economic agents in their saving and investment decisions, as well as in wage determination.*

2.5 *The other important determinant of overall domestic expenditure is the rate of growth of government spending, since a large proportion of demand is derived from outlays on public consumption and investment. Given that the Government continues to play a major role in the economy, it is imperative that fiscal and monetary policies should complement each other in attaining the inflation objective, as one of the means for promoting macroeconomic stability.*

2.6 *In formulating monetary policy for the period ahead, the Bank closely examines all the potential sources of inflation. The influence of the various factors on inflation and the need for monetary policy response can be discerned from the behaviour of alternative measures of inflation. In this regard, the Bank has, in the past three years, closely watched trends in the 16 percent trimmed mean measure of core inflation to aid policy formulation. This measure of inflation removes extreme price fluctuations from headline inflation. For this reason, it is a good indicator of the general trend in price changes. Another alternative measure of price trends is the exclusion method, which enables policy to focus on price changes that are more directly under the Bank's influence. The publication of both measures of inflation will broaden public understanding of inflation trends and the basis of monetary policy action in restraining inflationary pressures[2].*

[2] *The 16 percent trimmed measure of inflation removes 16 percent of extreme price changes (8 percent of the largest price changes and 8 percent of the smallest price changes), regardless of their source, from the headline measure of inflation. On the other hand, the exclusion measure of core inflation excludes items for which prices are not market determined, i.e., administered prices, such as utility tariffs and fees for government services. The Central Statistics Office will publish the 16 percent*

2.7 *While the use of alternative measures of price changes helps in the assessment of sources of inflation, the Bank will respond to any source of inflation in order to forestall a climate of generalised acceleration in price increases. Meanwhile, the rebasing of the Consumer Price Index (CPI) to September 2006, and the related changes in the formula, as well as the expanded number of items, should provide a better indication of the changes in the cost of living than was the case before. From this perspective, the new CPI series contributes towards an improvement in monetary policy formulation*[3].

3. INFLATION TRENDS IN 2006

3.1 *Inflation accelerated between January and April 2006, before declining in May 2006. The generalised decrease in the rate of price increase was reflected in a decline in the 16 percent trimmed mean measure of inflation, from 11.1 percent in December 2005 to 7.6 percent in December 2006, and a fall in headline inflation from 11.4 percent in December 2005 to 8.5 percent at the end of the year. Nevertheless, both measures of inflation were still above the desired range of 4 – 7 percent set for the year.*

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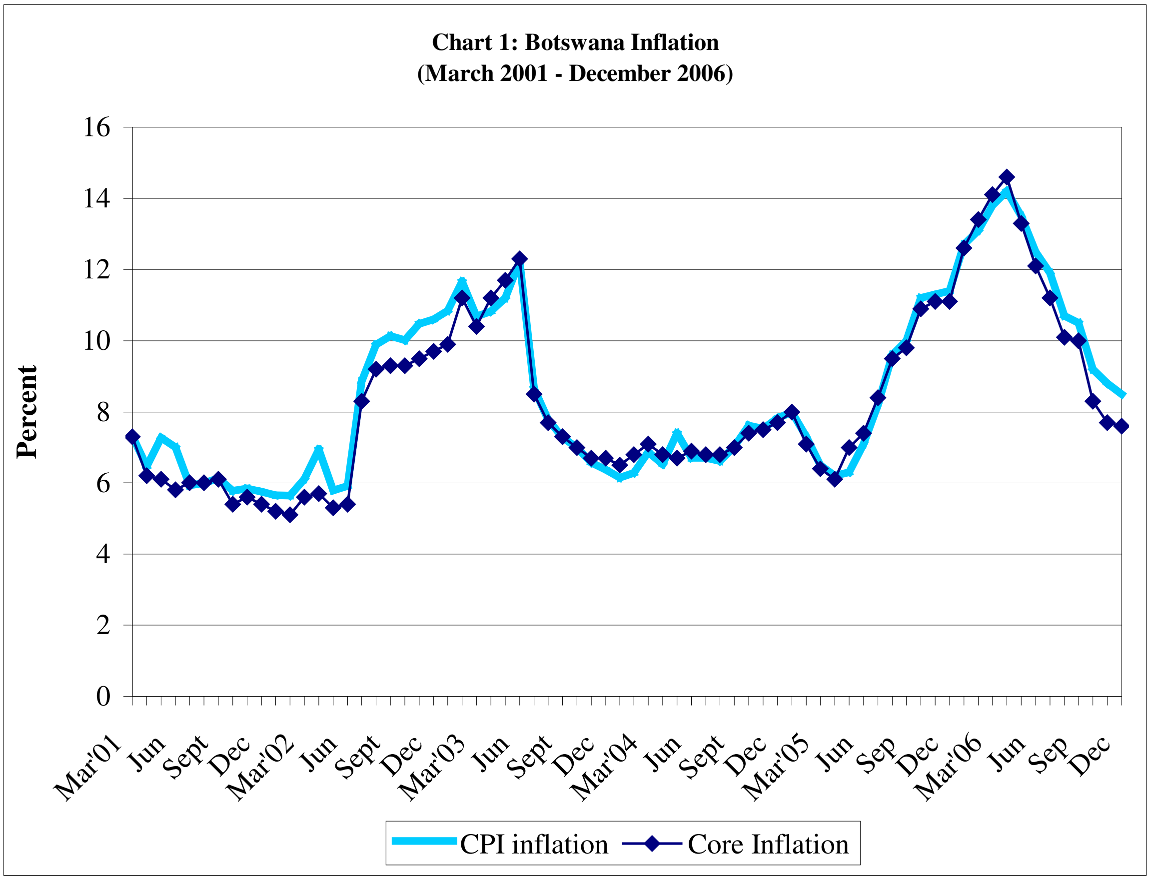
trimmed mean inflation data together with the core inflation measure that excludes administered prices in early 2007.

[3] *The CPI has been rebased to September 2006, with a new basket comprising a wider range of goods and services and revised weights based on the 2002/03 Household Income and Expenditure Survey (HIES) results. This is a change from the November 1996 base, whose weights were based on the 1993/94 HIES findings. In addition to expansion of the basket coverage, the rebasing involved reclassification of items based on the "Classification of Individual Consumption by Purpose" (COICOP), reassignment of item weights, expanded area coverage, and change in methodology. The new basket has 384 items classified into 51 sections, compared to the old basket's 256 items classified into 31 sections, while the aggregate commodity groups remain unchanged at 12.*



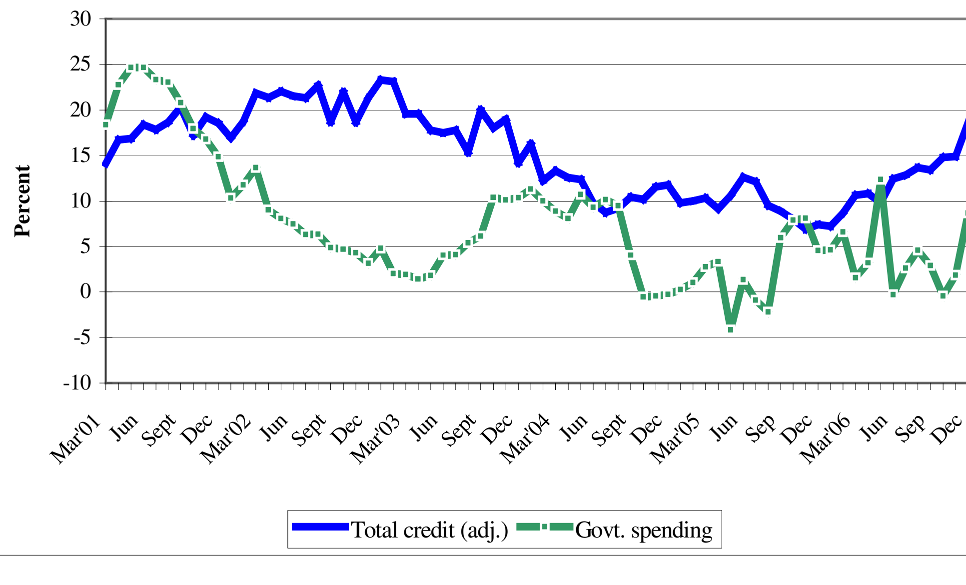
3.2 *Following a sustained increase in the second half of 2005, mainly due to the May 2005 devaluation, inflation accelerated further at the beginning of 2006 to a peak of 14.2 percent in April. The rise in inflation was due to the impact of the re-introduction of school fees in government secondary schools and the effect of the 40 percent increase in beef producer prices. Moreover, the increase in fuel prices contributed modestly to the upward trend in inflation.*

3.3 *However, from May 2006 inflation fell steadily as the impact of the May 2005 devaluation gradually fell out of the inflation calculation. Other causes of the downward trend in inflation included the decline in fuel prices in the fourth quarter of the year, which contributed 0.44 percentage points to the slowdown. There were, however, some price movements that tended to reverse the declining inflation trend in the fourth quarter. These included the rebalancing of telecommunication tariffs and the increase in electricity tariffs and transport fares; the initial inflationary contributions of these price changes to inflation were 0.81 percent, 0.13 percent and 0.44 percent, respectively.*

3.4 *Besides other supply shock factors, subdued overall domestic activity had a dampening effect on inflation. Gross domestic product (GDP) declined by 0.8 percent in 2005/06 compared to a revised 9.2 percent GDP growth in 2004/05,* *mostly due to a 4.4 percent decrease in diamond output[4]. When mining is excluded, GDP growth was 1.8 percent in 2005/06, which was lower than the 3.3 percent of the previous year. The non-mining private sector (government excluded) output expansion was only 0.9 percent in 2005/06 compared to 2.9 percent in 2004/05.*

3.5 *The overall effect of demand pressure on inflation was moderate, particularly given a relatively restrictive monetary policy and a lower growth rate in government expenditure in 2006, compared with the budgeted annual increase for fiscal year 2006/07. However, credit to the private sector accelerated from 7.4 percent in December 2005 to 18.6 percent at the end of 2006, and was for the last two months of the year above the upper end of the 11 – 14 percent range, which was considered consistent with the Bank's 2006 inflation objective. This credit expansion was partly explained by the 2006/07 Budget measures, especially the 8 percent increase in civil service salaries and the expansionary tax adjustments, which raised income levels as a basis for access to borrowing. Moreover, the projected faster increase in government expenditure, which normally supports private sector activity, may have generated expectations of business expansion derived from government projects. The year-on-year increase in lending to households rose from 9.3 percent at the end of 2005 to 16.4 percent in December 2006, while growth in borrowing by businesses accelerated from 4.8 percent to 21.7 percent over the same period (Chart 2).*

Chart 2: Annual Growth Rates of Credit and Government Spending (March 2001 - December 2006)



3.6 *In the event, despite a budgeted growth of 14.9 percent in total recurrent and development expenditure, the outturn for government spending for the 2006 calendar year was only 8.7 percent higher than that of 2005. The lower annual*

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4 *Due to the production scheduling of the diamond mining company, the recorded output contraction on a national accounts year basis reflects production fluctuations that are consistent with calendar year planning by the mines. On a calendar year basis, diamond output grew by 3.4 percent in 2006.*

rate of increase in government expenditure contributed to moderate demand pressures, and was supportive of the Bank's monetary policy stance, in an environment in which inflation was above the objective and the rate of growth of credit to the private sector was accelerating.

3.7 *External influences on domestic inflation were benign. This was due to the fact that buoyant world output growth, competition and restrictive monetary policy in the major economies contained the inflationary effect of oil price increases. World GDP growth was estimated at 5.1 percent in 2006, compared to 4.9 percent in 2005, with particularly robust performance in China, India, UK, USA and Japan*[5]*. Generally, consumption demand across the world benefited from improvements in investment and productivity; hence, there was a relatively lower rate of price increase for tradeables, especially for non-food consumption and durable goods. However, the large increase in international oil prices in 2005, which continued into the first half of 2006, contributed to a rise in global inflation, from 3.7 percent in 2005 to 3.8 percent in 2006.*

3.8 *With regard to the SDR countries*[6]*, inflation averaged 3.3 percent in December 2006 (higher than the 2.5 percent in 2005), while in South Africa, the CPIX*[7] *rate of inflation rose from 4 percent in December 2005 to 5 percent in December 2006, thus remaining within that country's target range of 3 – 6 percent. As a result, the trade-weighted average inflation for Botswana's trading partner countries rose from 3.5 percent in December 2005 to 4.2 percent in December 2006, with an overall moderate influence on inflation in Botswana. Chart 3 shows a comparison of inflation trends for Botswana and trading partner countries.*

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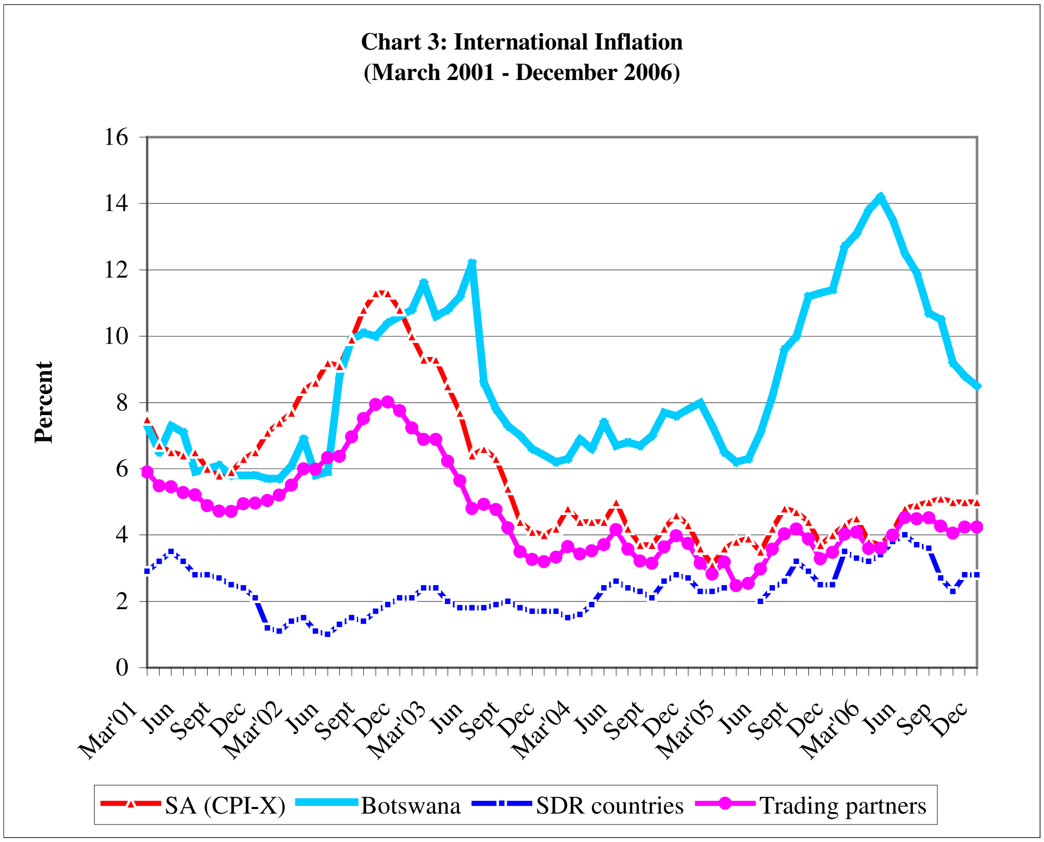
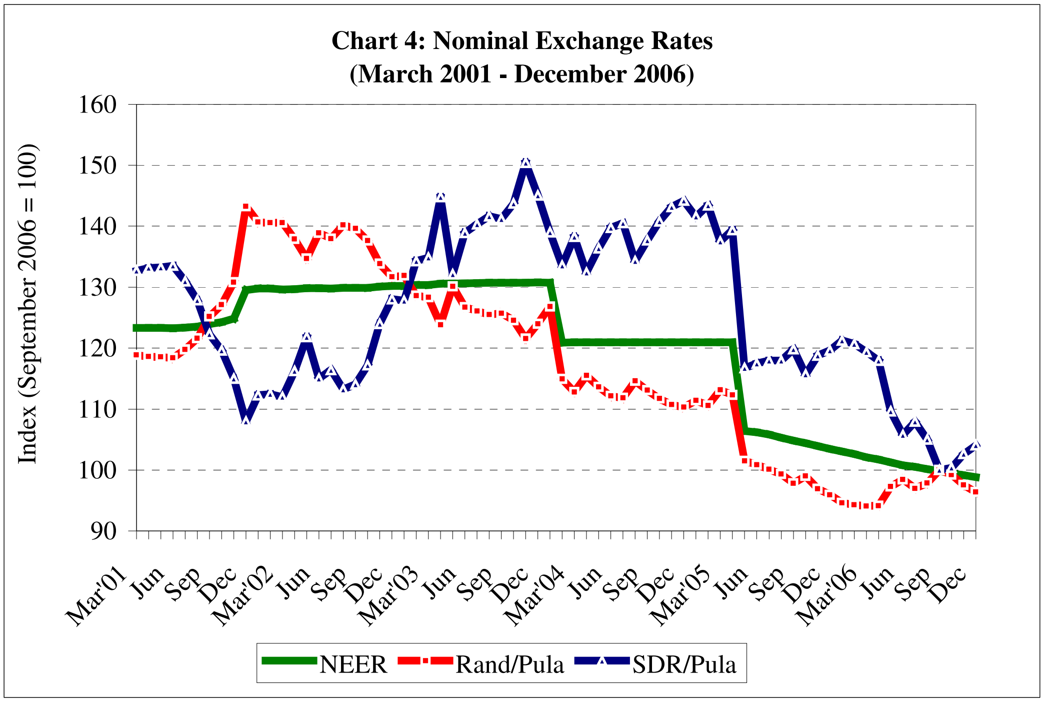
5 *All estimates for global developments are drawn from the International Monetary Fund's World Economic Outlook.*

6 *USA, UK, Japan and Euro Zone.*

7 *CPIX refers to the South African consumer price index which excludes mortgage interest rates.*



3.9 *At the beginning of 2006, the inflation objective was set higher than the forecast weighted average of inflation of trading partner countries. As a result, the nominal effective exchange rate (NEER) crawled downwards and depreciated by 4.5 percent in the twelve months to December 2006. On a bilateral basis, the Pula depreciated by 13 percent against the SDR and by 8.6 percent against US dollar; it appreciated by 0.5 percent against the South African rand in the same period. The marginal appreciation against the South African rand and moderate inflation in trading partner countries led to benign external pressures on domestic inflation. Meanwhile, the real effective exchange rate (REER) depreciated by 0.6 percent in the twelve months to December 2006, as the downward crawl more than offset the differential between inflation in Botswana and in trading partner countries.*



4. MONETARY POLICY IMPLEMENTATION IN 2006

4.1 The 2006 annual inflation objective was set at 4 – 7 percent to reflect the outlook for higher inflation in the short-term. This was in view of the continuing transitory impact of the May 2005 devaluation, re-introduction of fees in public secondary schools and the increase in other administered prices, including fuel. In the circumstances, it was considered desirable to accommodate some of the direct inflationary effects of these developments.

4.2 The Bank also introduced the three-year (2006–08) medium-term inflation objective of 3 – 6 percent with a view to anchor long-term inflation expectations and underscore commitment to sustainable price stability. In deciding to move towards achieving the medium-term objective through a gradual path, the Bank was avoiding wider economic costs which could result from forgone output growth and employment in the context of a stringent monetary policy tightening in the short-run.

4.3 In fact, the expectation was that inflation would peak in the second quarter of 2006, and fall thereafter as the impact of the May 2005 devaluation dissipated. Nevertheless, the Bank was concerned about the impact that high inflation would have on expectations. Accordingly, the Bank Rate was raised by 50 basis points to 15 percent in February 2006 and was maintained at this level throughout the year. Overall, therefore, monetary policy remained restrictive in 2006, as inflation was above the Bank's annual objective. In the event, inflation decreased towards the Bank's objective of 4 – 7 percent and was 8.5 percent in December 2006.

4.4 In addition to the reduced level of inflation, the implementation of the downward crawl of the nominal exchange rate contributed to achieving REER stability in *support of the broader national objective of economic diversification. The rate of crawl was set on the basis of the differential between the upper end of the Bank's inflation objective and the lower end of the 2006 inflation forecast for trading partner countries. The fall in domestic inflation towards the upper end of the Bank's inflation objective occurred at a time when inflation in trading partner countries edged up slightly, thus resulting in a narrowing of the inflation differential to a level almost equal to the rate of crawl. Consequently, the REER was virtually unchanged in the twelve months to December 2006.*

4.5 The Bank's open market operations supported monetary policy by absorbing excess liquidity in the financial system to ensure that short-term interest rates, particularly yields on Bank of Botswana Certificates (BoBCs), were consistent with the Bank's restrictive monetary policy stance. The yield on the 3-month BoBCs ranged between 12.20 percent and 12.74 percent, while that of the 14-day BoBCs ranged between 12.27 percent and 12.77 percent, in the twelve months to December 2006. Similarly, the average prime lending rate increased from 16 percent to 16.5 percent, while the average 88-day deposit rate increased from 8.88 percent to 8.96 percent. However, deposit rates subsequently fell, and averaged 8.38 percent by the end of the year due, in part, to the lacklustre progress by the commercial banks in developing competitively priced products for customers that previously held BoBCs.

4.6 The yield curve was inverted as short-term interest rates continued to be higher than long-term interest rates. This was indicative of the preference by investors (predominantly pension funds) for longer-dated instruments, as well as expectations of a fall in inflation and a decline in interest rates in the medium- to long-term. Given the falling inflation in 2006, real interest rates increased and the real 14-day and 3-month BoBC interest rates rose from 0.8 percent in December 2005 to 3.9 percent in December 2006. Similarly, the real prime lending rate increased from 4.1 percent in December 2005 to 7.4 percent in December 2006. The comparable real 3-month money market interest rates were 3.3 percent, 0.6 percent, 2.4 percent and 1.6 percent for South Africa, UK, USA and the euro zone, respectively.

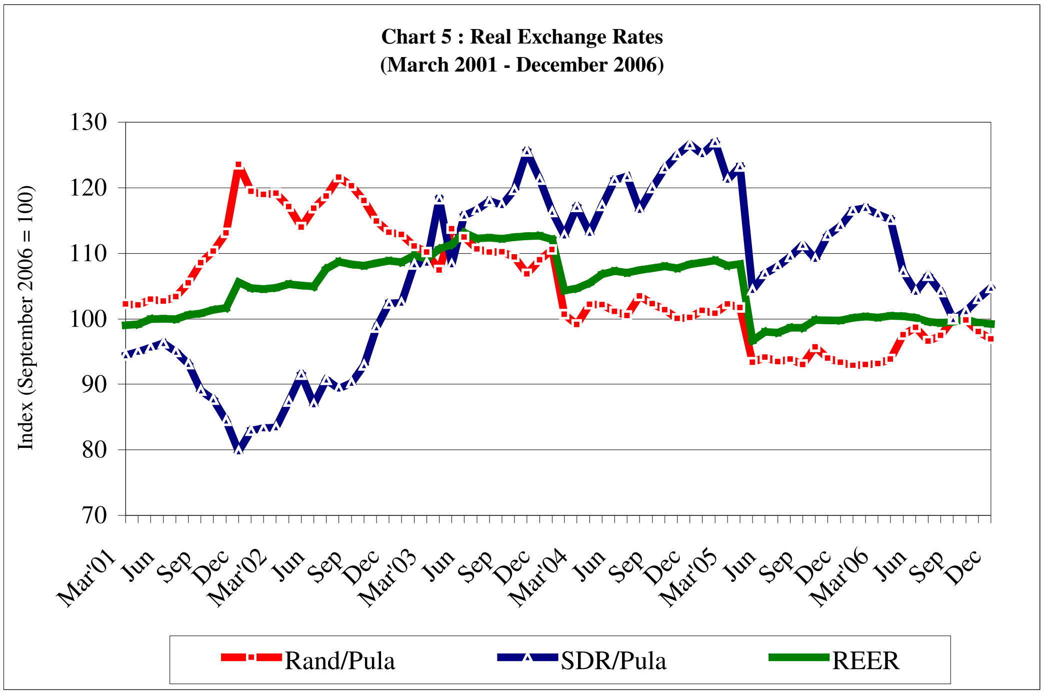


Chart 5 : Real Exchange Rates
(March 2001 - December 2006)
Index (September 2006 = 100)
130
120
110
100
90
80
70
Mar'01 Jun Sep Dec Mar'02 Jun Sep Dec Mar'03 Jun Sep Dec Mar'04 Jun Sep Dec Mar'05 Jun Sep Dec Mar'06 Jun Sep Dec
Rand/Pula
SDR/Pula
REER

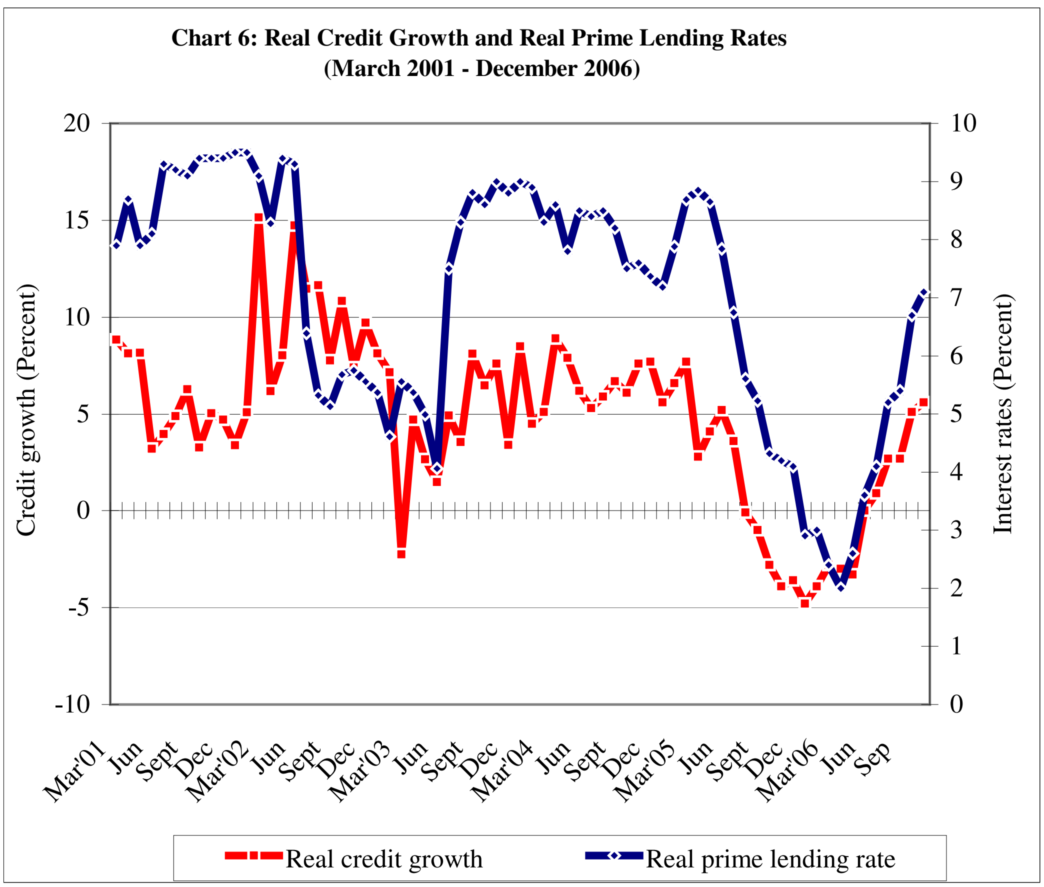
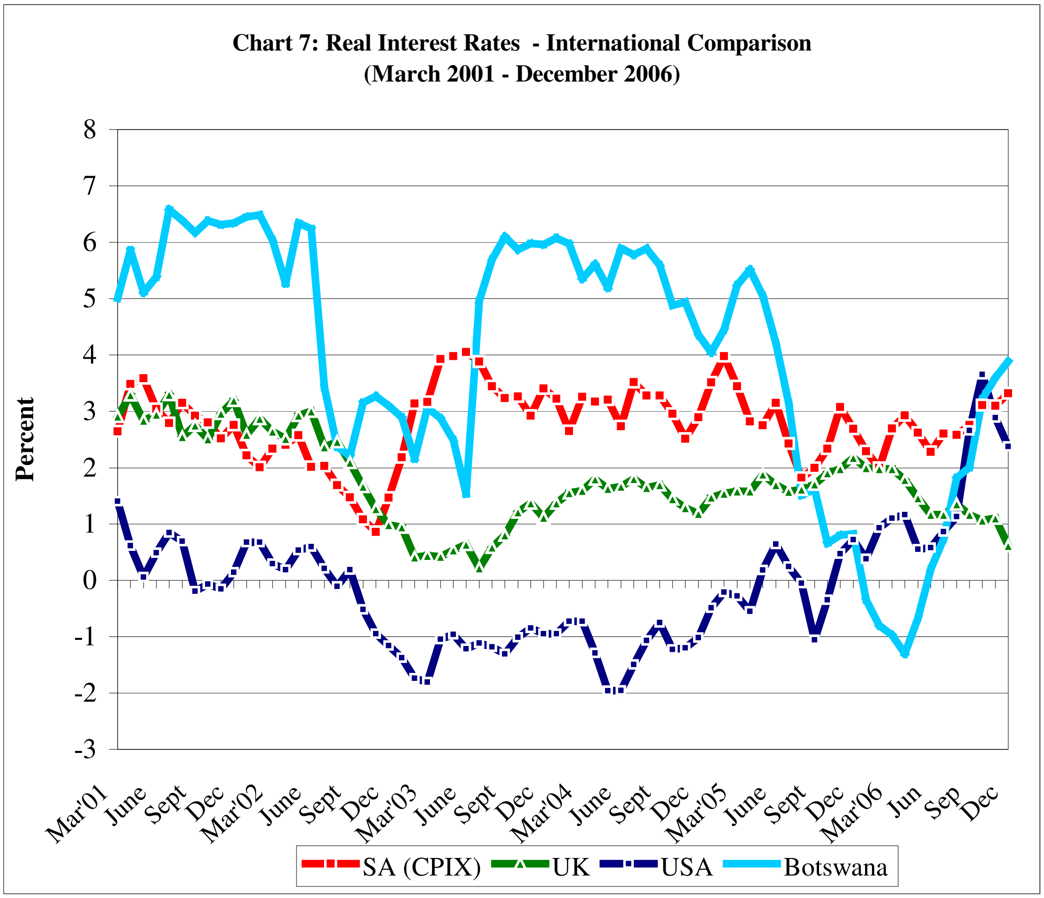


Chart 6: Real Credit Growth and Real Prime Lending Rates
(March 2001 - December 2006)
Credit growth (Percent)
20
15
10
5
0
-5
-10
Interest rates (Percent)
10
9
8
7
6
5
4
3
2
1
0
Mar'01 Jun Sept Dec Mar'02 Jun Sept Dec Mar'03 Jun Sept Dec Mar'04 Jun Sept Dec Mar'05 Jun Sept Dec Mar'06 Jun Sep
Real credit growth
Real prime lending rate



5. ***OUTLOOK FOR INFLATION IN 2007***

5.1 *It is anticipated that global economic performance will remain buoyant in 2007, with output growth forecast to be more or less the same as that of 2006 (5 percent). The positive growth outlook is underpinned by a continued robust demand despite monetary policy tightening in several major economies, which is supported by sustained expansion of supply capacity in emerging Asian countries, particularly China and India.*

5.2 *Despite the forecast buoyant output expansion, it is expected that global inflationary pressures will continue to be restrained as a result of competitiveness in the goods market, productivity gains, as well as monetary policy vigilance and continued successful management of inflation expectations. Although world inflation rose from 3.7 percent in 2005 to 3.8 percent in 2006, mainly as a result of the increase in the price of oil, which peaked at a record US$78.40 in mid-July, global inflation is forecast to fall back to 3.7 percent in 2007. SDR countries' average inflation is forecast to fall from 2.8 percent in 2006 to 2.2 percent in 2007.*

5.3 *South Africa's CPIX is projected to peak at marginally above the upper end of the target range of 3 – 6 percent in the first half of 2007. It is forecast to average 5.4 percent in 2007 compared to 4.7 percent in 2006. The expected rise in the CPIX* *is largely influenced by the projected increase in house prices and the continuing strong household consumption growth as reflected by the strong credit expansion.*

5.4 *Domestic demand pressures are expected to remain moderate in 2007 in the context of a relatively restrictive monetary policy. Following a sustained increase in 2006, credit growth should remain around the current level, given a moderate increase (6 percent) in civil service salaries and the current relatively high level of interest rates. However, the budgeted increase in government expenditure of 18 percent for 2007/08 is expansionary relative to demand conditions that the Bank considers consistent with its low inflation objective. It is, nevertheless, anticipated that, due to the continuing implementation capacity constraints, as well as the improved and stricter government procurement guidelines, the budgeted growth in government expenditure is not likely to be fully realised, thus resulting in a possible dampening effect on credit demand by the private sector.*

5.5 *The rate of crawl of the exchange rate, which is based on the differential between the Bank's inflation objective and forecast inflation of trading partner countries, is not expected to result in a substantial nominal exchange rate adjustment during 2007, particularly against the South African rand[8]. The crawl should, therefore, not add significantly to inflationary pressures, particularly in an environment of a relatively restrictive monetary policy.*

5.6 *However, any relatively large upward adjustment in administered prices could significantly reverse the gains made on the inflation front. This consideration reinforces the need for discernible productivity improvements and cost containment by parastatals and the Government, in order to avoid the need for potentially large price increases. While there is still uncertainty with respect to the direction of international oil prices, in part due to political tension in the Middle East, the balance of risks appears to be on the downside, and this should lessen the risk of domestic inflationary pressures that could result from an increase in fuel prices.*

5.7 *Overall, given the expected continuation of moderate demand pressures, modest changes in the rand/Pula exchange rate and the increasing effect of the monetary policy stance on expectations, it is anticipated that, in the absence of large increases in administered prices, inflation will stabilise at around 7 percent by the second quarter of 2007. Therefore, to the extent that demand pressures are contained through an effective monetary policy stance, supportive fiscal policy and restraint by parastatals in raising tariffs, inflation should generally trend towards the Bank's medium-term objective of 3 – 6 percent.*

6. *MONETARY POLICY STANCE IN 2007*

6.1 *As indicated above, the objective of monetary policy is price stability, which also contributes towards achieving REER stability through attaining the level of*

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8 *Even in the context of a downward crawl of the NEER and given the basket mechanism and movements in cross exchange rates, changes in bilateral exchange rates against the Pula will not always be downward.*

inflation that is not higher than the average inflation of trading partner countries. To the extent that Botswana's inflation objective is higher than the average inflation of trading partner countries, the nominal exchange rate has to crawl downwards in order to avoid the appreciation of the REER due to the inflation differential. For 2007, the forecast inflation for trading partner countries is in the range of 4 - 6 percent. This would suggest a lowering of the upper end of the inflation objective of 4 - 7 percent, in order to achieve a competitive real effective exchange rate, without a need to adjust the nominal exchange rate. However, it is anticipated that inflation will remain above 6 percent in 2007, partly due to the continuing effects of administered price increases that occurred in the second half of 2006.

6.2 While it is desirable to achieve a faster reduction in inflation from the current level, it is considered that it is possible to achieve a measured reduction in inflation over the medium-term without unduly sacrificing growth and employment prospects in the short-term. It is also considered that the modest rate of crawl required to achieve REER stability would not jeopardise the Bank's inflation objective, while being supportive of export competitiveness in pursuit of the national economic diversification objective.

6.3 It is, therefore, important that, in the absence of a rapid reduction in demand and inflation, monetary policy should remain relatively tight to restrain the second-round effects of the increase in administered prices and to sustain expectations of a fall in inflation towards the Bank's medium-term objective. Hence, the Bank has decided to maintain the 4 – 7 percent inflation objective for 2007. Given that the upper end of the inflation objective is higher than forecast inflation for trading partner countries, the NEER of the Pula will crawl downwards in 2007 in order to achieve REER stability.

6.4 Moreover, the Bank's medium-term inflation objective of 3 – 6 percent recognises the need for a gradual path towards achieving a low and sustainable level of inflation, taking account of the time lags of the transmission process for policy changes to ultimately affect inflation.

6.5 As indicated above, the expansionary 2007/08 government budget calls for a tight monetary policy stance that will moderate the resultant demand pressures. Accordingly, credit growth in 2007 will be confined to a range of 11 – 14 percent. This is derived from the projected growth of the non-mining sector of the economy (aggregate supply) and the inflation objective, with an allowance for the process of financial deepening as the economy develops.

7. SUMMARY AND CONCLUSIONS

7.1 Inflation maintained an upward trend in the first four months of 2006 due, in the main, to the residual effects of the May 2005 devaluation and the impact of the re-introduction of fees in government secondary schools, as well as a large increase in the cost of meat products. It subsequently slowed down to 8.5 percent by year-

end, which is 1.5 percentage points higher than the upper end of the 2006 inflation objective.

7.2 *This year, global inflation is expected to be benign due to, among others, continuing productivity improvements, competition and anti-inflation policies in trading partner countries. Domestically, demand pressures on inflation should be restrained by a relatively restrictive monetary policy, and the possibility that budgeted growth in government expenditure may not be realised in view of persistent capacity constraints. There is, however, an upside risk to inflation associated with a possible relatively large increase in some administered prices.*

7.3 *The challenge for monetary policy in 2007 is, therefore, to ensure that the downward trend in inflation is sustained in order to realise the Bank's annual inflation objective of 4 – 7 percent, on the path towards achieving the 3 – 6 percent medium-term inflation objective. To this end, the Bank remains committed to responding appropriately to all economic and financial developments in order to keep inflation under control.*