

MID-TERM REVIEW OF THE 2013 MONETARY POLICY STATEMENT

1. INTRODUCTION

- 1.1 *The Mid-Term Review (MTR) of the 2013 Monetary Policy Statement (MPS) evaluates progress in achieving the 3 – 6 percent medium-term inflation objective. In that respect, the MTR reviews recent price developments and assesses key financial and economic developments that will have an impact on the inflation outlook and, in turn, the likely monetary policy response in the second half of 2013. Through this approach, the Bank aims to promote policy credibility with a view to anchoring public expectations of a low, predictable and sustainable level of inflation.*
- 1.2 *The Bank's definition of price stability is inflation in the 3 – 6 percent range that is consistent with sustainable long-run growth of the economy. Low inflation, which is proximate to trading partner inflation, contributes to stability of the real effective exchange rate (REER), promotes international price competitiveness of domestic producers and supports economic growth.*
- 1.3 *Domestic output expansion was moderate in the first half of 2013, and generated low demand pressures on inflation. As anticipated at the launch of the 2013 MPS, inflation declined from 7.4 percent in December 2012 to 5.8 percent in June 2013,¹ thus falling within the objective range. The decrease in inflation was influenced by the base effects associated with the increase in administered prices in the first six months of 2012, as well as the slowdown in the rate of price increase for most categories of goods and services in the first half of 2013. On account of the positive medium-term outlook for price developments, the Bank Rate was cut by a cumulative 100 basis points in the first half of 2013 to 8.5 percent.²*
- 1.4 *Global economic activity is expected to remain subdued, given recession in the Euro Area, slowing growth in some key emerging market economies and weaker domestic demand. In the short term, world growth prospects are negatively affected by fiscal austerity, bank deleveraging and high unemployment rates in major economies. World GDP is, therefore, forecast to grow at 3.1 percent in 2013, the same as in 2012, before accelerating to 3.8 percent in 2014.³*

¹ *Inflation decreased further to 5.7 percent in July 2013.*

² *The Bank Rate was reduced by 50 basis points each in April and June 2013. A 50 basis points reduction was effected in August, with the Bank Rate falling to 8 percent.*

³ *IMF's World Economic Outlook (WEO) Update of July 2013 downgraded growth forecasts from those contained in the April 2013 WEO.*

2. MONETARY POLICY FRAMEWORK

- 2.1 *The Bank's monetary policy objective is to achieve price stability, as represented by a level of inflation that is within the medium-term objective range of 3 – 6 percent. Such a low and predictable level of inflation contributes to the broader national objective of sustainable economic growth and development that can be attained through savings mobilisation and productive investment; it also fosters international competitiveness of domestic producers.*
- 2.2 *The monetary policy framework entails assessing prospective developments in various factors that can influence price movements, thereby allowing the Bank to generate an inclusive and broad-based forecast for inflation in the medium term that, in turn, informs the monetary policy response. In this way, the Bank determines the factors (including public expectations) that are likely to lead to a longer-lasting deviation of inflation from the objective range and those that have a transitory impact, as indicated by the duration of their disaggregated effect on the inflation forecast.*
- 2.3 *In pursuing the objective of price stability, the Bank uses interest rates and open market operations to affect demand conditions in the economy and, ultimately, the rate of increase in prices. Changes in interest rates and the availability of loanable funds influence choices with respect to credit demand and saving; and ultimately, the determination of aggregate demand. Domestic demand conditions⁴ and other factors, such as foreign inflation, exchange rate, changes in administered prices and taxes, contribute to the level of inflation. Public expectations with respect to the future level of inflation also influence price changes by firms and wage adjustments.*
- 2.4 *The Bank monitors the output gap⁵ as a leading indicator of the direction of inflation based on factors that cause domestic demand to deviate from the economy's capacity to supply goods and services (long-term output trend). A sustained level of economic performance above trend is potentially inflationary and could signal the need to increase interest rates to dampen inflationary pressures, while output below trend could require a reduction of interest rates to stimulate economic activity. In general, the Bank will adjust monetary policy in response to a sustained deviation of the inflation forecast from the objective range, and where the causal factors could be influenced by monetary policy action.*
- 2.5 *Accordingly, the Bank's Monetary Policy Committee (MPC) meets regularly for a timely review of economic developments, related inflation outlook and the direction of monetary*

⁴ *In this instance, the rate of change in prices is associated with the variation in demand/supply conditions in the economy, influenced by a change in interest rates and the exchange rate. Technically, this relates to the net impact of changes in real interest rates and real exchange rates, referred to as "real monetary conditions", on the availability of credit and domestic industry competitiveness.*

⁵ *The output gap refers to the difference between long-term trend output (as an indicator of productive capacity) and actual output. 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.*

policy. The outcome of the MPC deliberations is disseminated to stakeholders immediately after each meeting in order to help anchor inflation expectations and contribute towards sustained policy credibility, which is critical in achieving long-term price stability.

- 2.6 *Price stability supports international competitiveness of domestic producers through stabilising the real effective exchange rate (REER), in the context of the crawling band exchange rate policy. The REER is a composite exchange rate of the Pula, comprising the South African rand (55 percent) and the Special Drawing Rights (SDR – 45 percent) adjusted for inflation. The weights used to determine the Nominal Effective Exchange Rate (NEER) or Pula basket reflect the pattern of trade with South Africa and the respective SDR countries⁶. In this respect, attaining inflation equal to that prevailing in trading partner countries would indicate that Botswana producers are competitive at the existing NEER. This is a key rationale for having a 3 – 6 percent inflation objective range, which approximates inflation in trading partner countries.*
- 2.7 *In the event that inflation in Botswana differs from that of trading partner countries, a stable REER can be attained by adjusting the NEER of the Pula to the extent of the inflation differential. This means that when Botswana's inflation objective is higher than the forecast average inflation of trading partner countries, there will be a downward crawl of the NEER in order to maintain international competitiveness of exports and domestic tradeable goods. Conversely, an upward crawl of the NEER would be effected when the domestic inflation objective is lower than forecast average inflation of trading partner countries. For 2013, the rate of crawl has been set at -0.16 percent. In the long term, the best way to achieve durable improvement in international competitiveness of domestic producers is through gains in productivity, which contributes to lower inflation.*
- 2.8 *Overall, the direction of both the REER and real interest rates, as measured by the real monetary conditions index (RMCI)⁷, provides an indication of policy performance and the likely influence of monetary policy on inflation and economic activity. Therefore, an increase in real interest rates and/or an appreciation of the REER would indicate a tightening of monetary conditions that would serve to mitigate inflationary pressures, but this could result in a slowdown in economic activity. Conversely, a decrease in real interest rates and/or a depreciation of the REER would imply a loosening of monetary conditions, which may be necessary to stimulate output growth; this could, however, be potentially inflationary.*

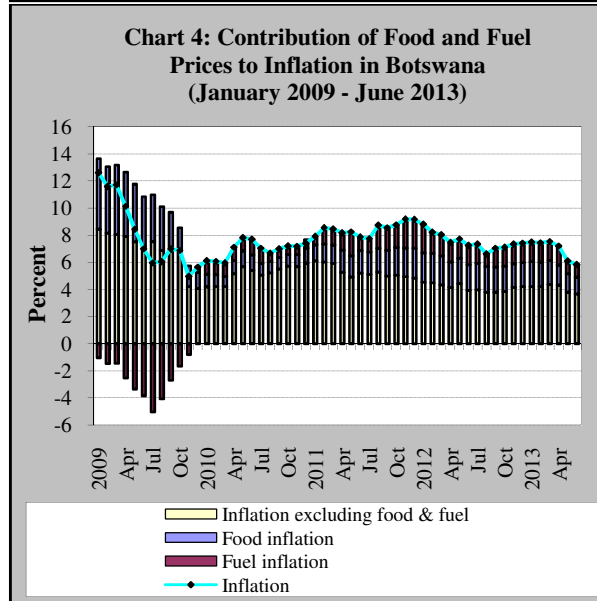
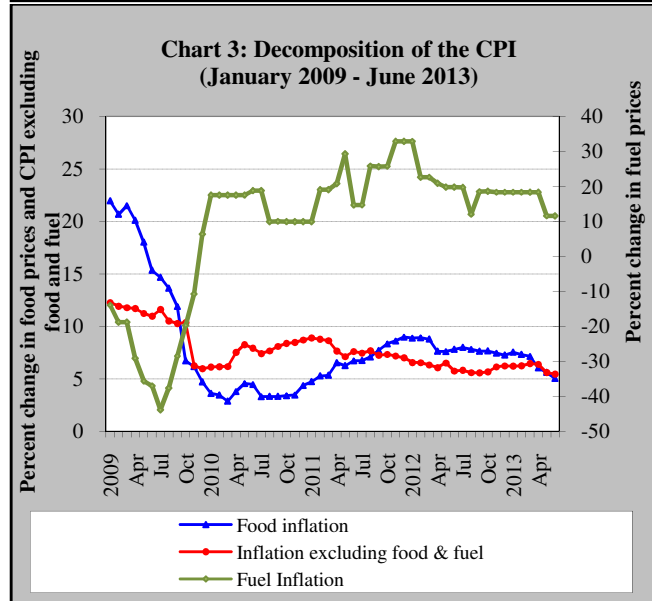
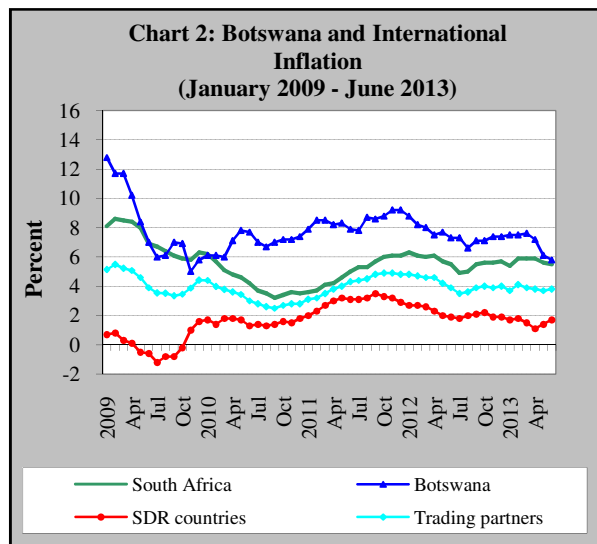
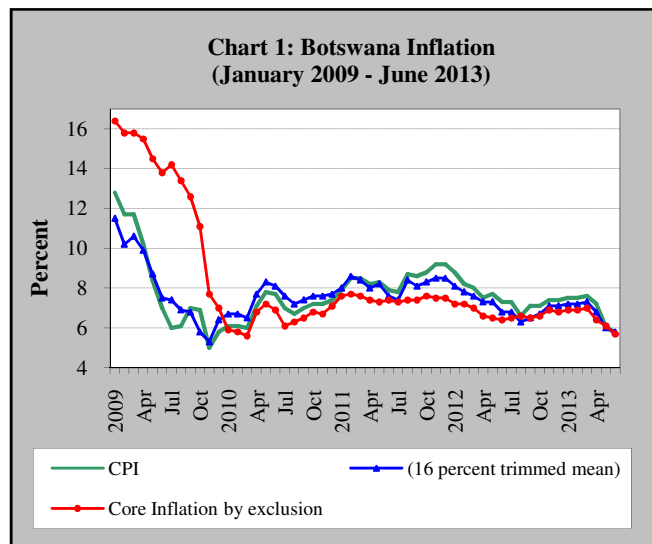
⁶ SDR countries are USA, Japan, Euro Area and the United Kingdom.

⁷ 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 an RMCI that combines, through a weighted average, the deviations of the real exchange rate and real interest rate from their respective trend values.

3. INFLATION IN THE FIRST HALF OF 2013

3.1 Inflationary pressures eased across the world in the first half of 2013 owing to the stable commodity prices and subdued growth in global demand and sluggish economic activity. In addition, inflation is restrained by enduring capacity underutilisation and high unemployment rates in major economies. For Botswana's trading partner countries, average inflation moderated from 4 percent in December 2012 to 3.8 percent in June 2013. Headline inflation in South Africa fell slightly from 5.7 percent in December 2012 to 5.5 percent in June 2013, thus remaining within the South African Reserve Bank's target of 3 – 6 percent. For the SDR countries, inflation eased from 1.9 percent in December 2012 to 1.7 percent in June 2013 (Appendix I, Chart A3 shows inflation rates for SDR countries).⁸

⁸ *Considerable variation in price developments remains across constituent economies. For instance, UK inflation was significantly higher than that of other SDR countries in the first half of 2013, while Japan experienced deflation in the same period.*



Source: Statistics Botswana and Bank of Botswana

3.2 *Inflation in Botswana trended downwards in the first half of 2013; it decreased from 7.4 percent in December 2012 to 5.8 percent in June 2013, thus falling within the Bank’s objective range of 3 – 6 percent.⁹ Similarly, inflation excluding administered prices and the 16 percent trimmed mean inflation decreased from 6.8 percent and 7.1 percent, respectively, in December 2012 to 5.7 percent in June 2013. This generalised decrease in inflation measures is, in part, due to base effects associated with the increase in administered prices in the first six months of 2012. Furthermore, in the first half 2013, the annual rate of price increase was subdued for most categories of goods and services*

⁹ *Headline inflation was 7.6 percent in March 2013, largely reflecting the increase in the rate of annual price change for the alcohol and tobacco category.*

(notably food and housing). The appreciation of the Pula against the rand also helped moderate imported inflation.

- 3.3 Demand pressures on inflation were modest in the first six months of 2013 owing to below-trend domestic economic activity. The impact of government spending was small in the context of fiscal consolidation measures, with the annual government expenditure growth of 2.6 percent in March 2013, and the 17.9 percent annual decline in development spending. However, strong credit growth counteracted restrained growth in incomes and helped stabilise demand; it also supported economic activity. Even then, year-on-year credit expansion decelerated from 23.6 percent in December 2012 to 21.7 percent in June 2013. The slowdown in credit growth was due to a lower annual increase in lending to businesses (14.7 percent compared to 17.8 percent). The annual increase in credit to households also eased from 28.5 percent at the end of 2012 to 27.4 percent in June 2013.
- 3.4 The growth in credit is also associated with a significant increase in the intermediation ratio (the proportion of deposits at commercial banks that is converted to loans) from 68.6 percent in June 2012 to 76.4 percent in June 2013. The Bank continues to monitor credit developments in order to address any threats to financial stability. Currently, indicators, which include low and stable default ratios for household borrowing, suggest that widespread default risks are not imminent. Similarly, indicators of activity in the property sector suggest that the markets for residential and commercial property remain broadly balanced. Moreover, given the projected positive GDP growth, there is a low risk of a generalised loss of income.
- 3.5 Overall, broad money supply increased by 8.3 percent in the year to June 2013, thus reflecting the expansionary impact of the 21.5 percent increase in credit¹⁰, 7.1 percent rise in net foreign assets, while the 11.2 percent increase in government deposits at the Bank of Botswana was contractionary. Thus, money supply growth supported output expansion, which is estimated at 3.6 percent in the twelve months to March 2013. The modest GDP expansion reflects a contraction of 6.1 percent in mining output. Non-mining output increased by 5.2 percent, led by growth in the social and personal services (11.5 percent), finance and business services (10.8 percent) and construction at 10.4 percent.

¹⁰ Refers to credit offered by all deposit-taking institutions (commercial banks, Botswana Savings Bank and Botswana Building Society).

4. MONETARY POLICY IMPLEMENTATION IN THE FIRST HALF OF 2013

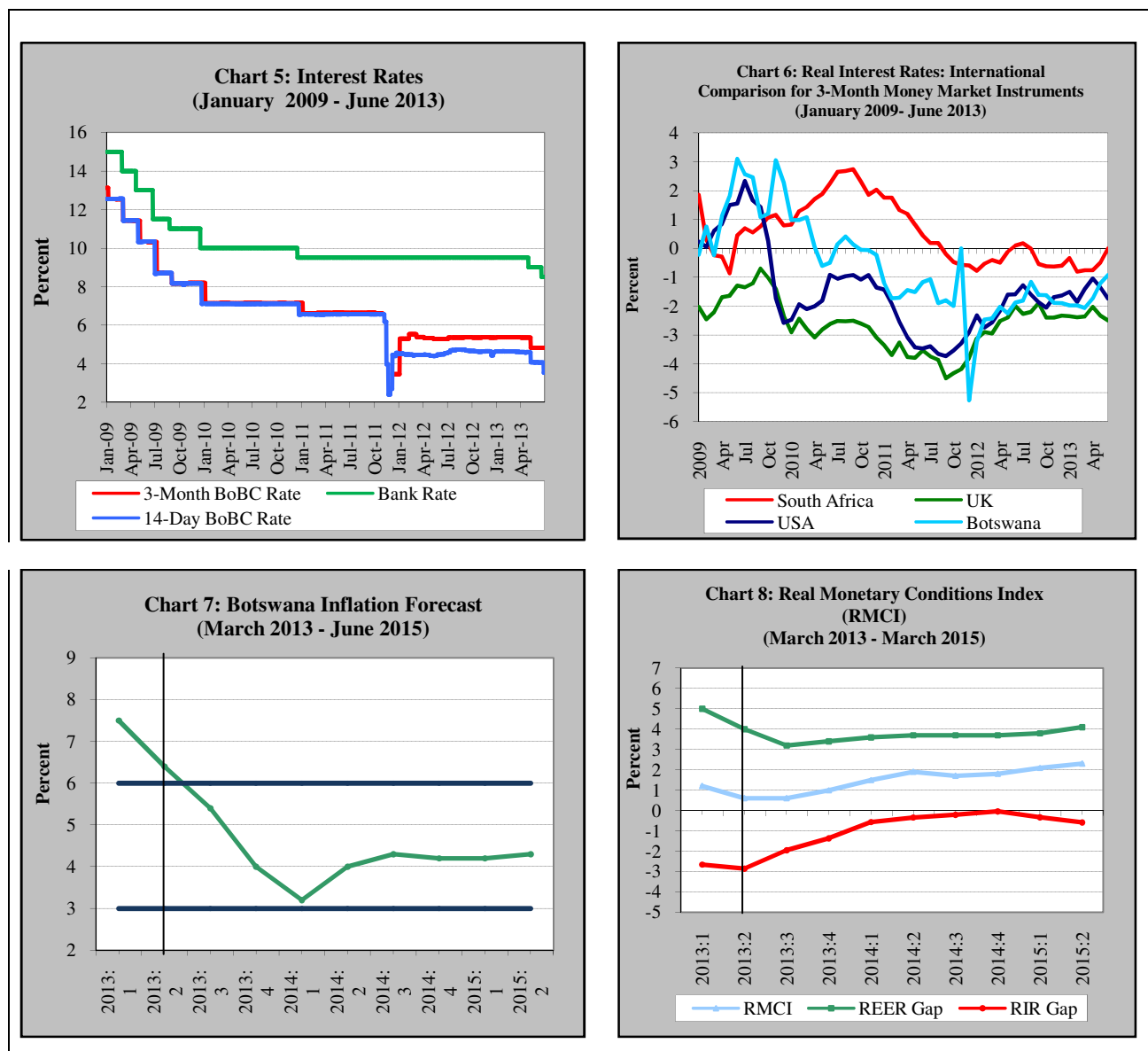
- 4.1 *Monetary policy was conducted against the background of modest world output growth, which was weighed down by prolonged recession in the euro area.¹¹ The policy focus revolved around mitigating the negative short-term effects of fiscal consolidation and bank deleveraging on economic activity, particularly in developed economies. Globally, inflationary pressures were low owing to stability in commodity prices and subdued growth in global demand. Notably, international oil prices stabilised at lower levels in the first half of 2013 due to a combination of sluggish demand and increase in supply. Weak global demand is also reflected in low capacity utilisation and relatively high unemployment rates in the major economies, leading to low pressures on inflation.*
- 4.2 *In the circumstances, monetary policy in advanced countries was generally accommodative, with several central banks, including the US Federal Reserve Bank (Fed), Bank of England (BoE), Bank of Japan (BoJ), European Central Bank (ECB) and Reserve Bank of Australia, maintaining policy interest rates at low levels or reducing them. Furthermore, major central banks maintained liquidity support and promoted growth in money supply.¹²*
- 4.3 *Similarly, in some emerging market economies, accommodative monetary policy was maintained to counteract the impact of weaker external demand and support domestic economic activity. Policy interest rates were unchanged in China and South Africa in the first half of the year, while India reduced its policy interest rate. However, the Central Bank of Brazil tightened monetary policy in response to emerging signs of accelerating inflation.*
- 4.4 *In Botswana, monetary policy was implemented in the context of below-trend production (negative output gap). Moreover, domestic demand pressures were modest, partly indicative of subdued growth in personal incomes and slow growth in government expenditure. In addition, foreign inflation was low, with benign pressure on domestic prices. These factors contributed to a positive medium-term outlook for inflation, and provided scope for non-inflationary stimulus to the economy. Hence, the Bank Rate was reduced by a cumulative 100 basis points to 8.5 percent in the first half of 2013.*
- 4.5 *Following the reduction in the Bank Rate, money market interest rates decreased (Chart 6).¹³ The yield on the 14-day Bank of Botswana Certificate (BoBC) fell from 4.64 percent at the end of December 2012 to 3.53 percent in June 2013, while the 3-month BoBC yield*

¹¹ *The recession also affected the largest economies of the area, with France relapsing into recession in the first quarter of 2013, and given a new two-year deadline by the European Commission to reduce its budget deficit to below 3 percent of GDP. The European Commission also gave Spain, Poland, Portugal, The Netherlands and Slovenia more time to complete their austerity plans amid concerns over growth prospects.*

¹² *For example, asset purchase programmes in the Euro Area, Japan, UK and the USA.*

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

eased from 5.36 percent to 4.82 percent in the same period.¹⁴ The prime lending rate of commercial banks fell from 11 percent in December 2012 to 10 percent in June 2013, while the 88-day deposit rate fell from 3.7 percent in December 2012 to 3.05 percent in June 2013.



Source: Bank of Botswana.

4.6 As a result of the decrease in inflation between December 2012 and June 2013, real interest rates increased but remained negative. The real interest rate for the 3-month BoBC rose from -1.9 percent in December 2012 to -0.93 percent in June 2013. Similarly,

¹⁴ The impact of the reduction in the Bank Rate (June 2013) on the 3-month BoBC is reflected in July 2013, as the BoBC is auctioned at the beginning of each month. Thus, the 3-month BoBC yield fell further to 4.05 percent in July 2013.

the 14-day BoBC real interest rate increased from -2.57 percent to -2.15 percent in the same period. At the same time, the real 88-day deposit rate rose from -3.45 percent in December 2012 to -2.6 percent in June 2013.

- 4.7 *The Bank implemented a modest downward crawl of the Pula exchange rate in line with the policy objective of maintaining a stable inflation-adjusted exchange rate of the Pula against a trade-weighted combination of trading partner country currencies. Domestic inflation was higher than the average inflation of trading partner countries, as a result of which the nominal effective exchange rate depreciated by 0.1 percent in the six months to June 2013. Bilaterally, the Pula weakened by 7.3 percent against the SDR (9.3 percent depreciation against the US dollar), but appreciated by 6.3 percent against the rand in the same period. The REER¹⁵ of the Pula appreciated by 0.1 percent in the six months to June 2013, owing to the positive inflation differential between Botswana and her trading partner countries being greater than the 0.16 percent rate of crawl of the NEER.*
- 4.8 *In the first half of 2013, the real interest rate gap was negative, thus implying easy financing conditions. However, this effect was more than offset by the restrictive positive real exchange rate gap. Overall, real monetary conditions were relatively tight, albeit stable throughout the first half of 2013.*

5. MEDIUM-TERM INFLATION OUTLOOK

- 5.1 *The forecast for inflation entails an assessment of likely changes in factors that affect domestic price movements, comprising demand and supply relationship, 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.¹⁶*
- 5.2 *It is anticipated that world economic growth will remain subdued, and reflective of the weak growth in the Euro Area¹⁷, modest domestic demand and slowing growth in some key emerging market economies, particularly China and India. World GDP is forecast to grow by 3.1 percent in 2013 (same as in 2012); it is expected to expand by 3.8 percent in 2014. Growth prospects in major economies are constrained by fiscal austerity, weak bank intermediation and the high unemployment rates, thus leading to weak demand. In the emerging market economies, growth is projected to ease due to sluggish external demand and lower export commodity prices. However, world economic expansion*

¹⁵ *The REER is calculated using Botswana's headline inflation, weighted average inflation for SDR countries and South African headline inflation.*

¹⁶ *Forecasts for external variables are obtained mainly from the Reuters survey of forecasters.*

¹⁷ *In order to stimulate more economic activity through improved credit flows, particularly to small and medium-sized enterprises, in July 2013, the European Central Bank amended its rules on acceptable collateral to include asset-backed securities with significantly lower credit ratings than before. Recent economic data suggest the recession in the euro area could be close to the end.*

appears sustainable, as supported by moderate but durable output increase in the USA, which is buoyed by a robust housing market and stronger growth in Japan induced by aggressive policy measures. In South Africa, GDP is forecast to grow by 2.2 percent in 2013, compared to 2.6 percent in 2012. The lower projection for output expansion reflects slower export growth resulting from the weak global economy.

- 5.3 *World inflation is projected to be restrained in the medium term, and decreasing from an average of 4 percent in 2012 to 3.8 percent in both 2013 and 2014, under the influence of stable commodity prices and continuing capacity underutilisation. International oil prices increased at the beginning of 2013 in response to tensions in the Middle East and positive business sentiment towards policy pronouncements in the USA and Japan, but subsequently fell as sluggish demand and weak economic activity prevailed. Going forward, it is expected that oil prices will stabilise as the increase by non-OPEC supplies continues to dampen the upward momentum of prices. However, there is a renewed upside risk to oil prices associated with the geopolitical unrest in the Middle East, particularly in Egypt¹⁸. World food prices also increased at the beginning of 2013, influenced by concerns that crop production would not be enough to replenish low inventories resulting from the 2012 drought. Nevertheless, the latest indications point to a more balanced world supply and demand in 2013/14, especially for cereals, compared to 2012/13. The regional outlook shows satisfactory conditions for the second half of 2013, mainly due to sizeable harvests across most countries, and this implies subdued pressure on domestic inflation.*
- 5.4 *Overall, it is expected that external price developments will have a benign influence on domestic inflation. In particular, the weighted inflation for trading partner countries is projected to average 3.8 percent in 2013. These price developments reflect low inflation in SDR countries, which is forecast to be 1.9 percent for 2013 and 2014, while headline inflation in South Africa is projected to remain within the 3 – 6 percent inflation target range until the end of 2014. However, the exchange rate and wage settlements are considered key risks to the medium term inflation outlook for South Africa.*
- 5.5 *It is projected that domestic output will remain below trend, but with modest overall growth derived from the performance of the non-mining sectors. The economic outlook is consistent with the Bank's March 2013 Business Expectations Survey (BES), which indicated an improvement in business confidence going forward. The projected negative output gap results in moderate demand pressures on inflation in the medium term and higher growth expectations from the second half of 2013.*
- 5.6 *The increase in administered prices in the second quarter of 2013 is estimated to add 0.24 percentage points to inflation, comprising the impact of the increase in electricity and water tariffs. Given a smaller number and lower rate of increase in administered prices in 2013 compared to 2012, the net outcome is a decrease in inflation due to base effects. Therefore, it is expected that inflation will be within the objective range for the*

¹⁸ *Egypt is not an oil producer, but its control of one of the world's busiest shipping corridors, the Suez Canal, places the country in a strategic position in global sources of energy supplies.*

remainder of 2013 (Chart 7).¹⁹ The relative strength of the Pula against the South African rand will also help restrain the impact of any regional pressures on inflation. 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 a further slowdown in global economic activity.

6. MONETARY POLICY STANCE

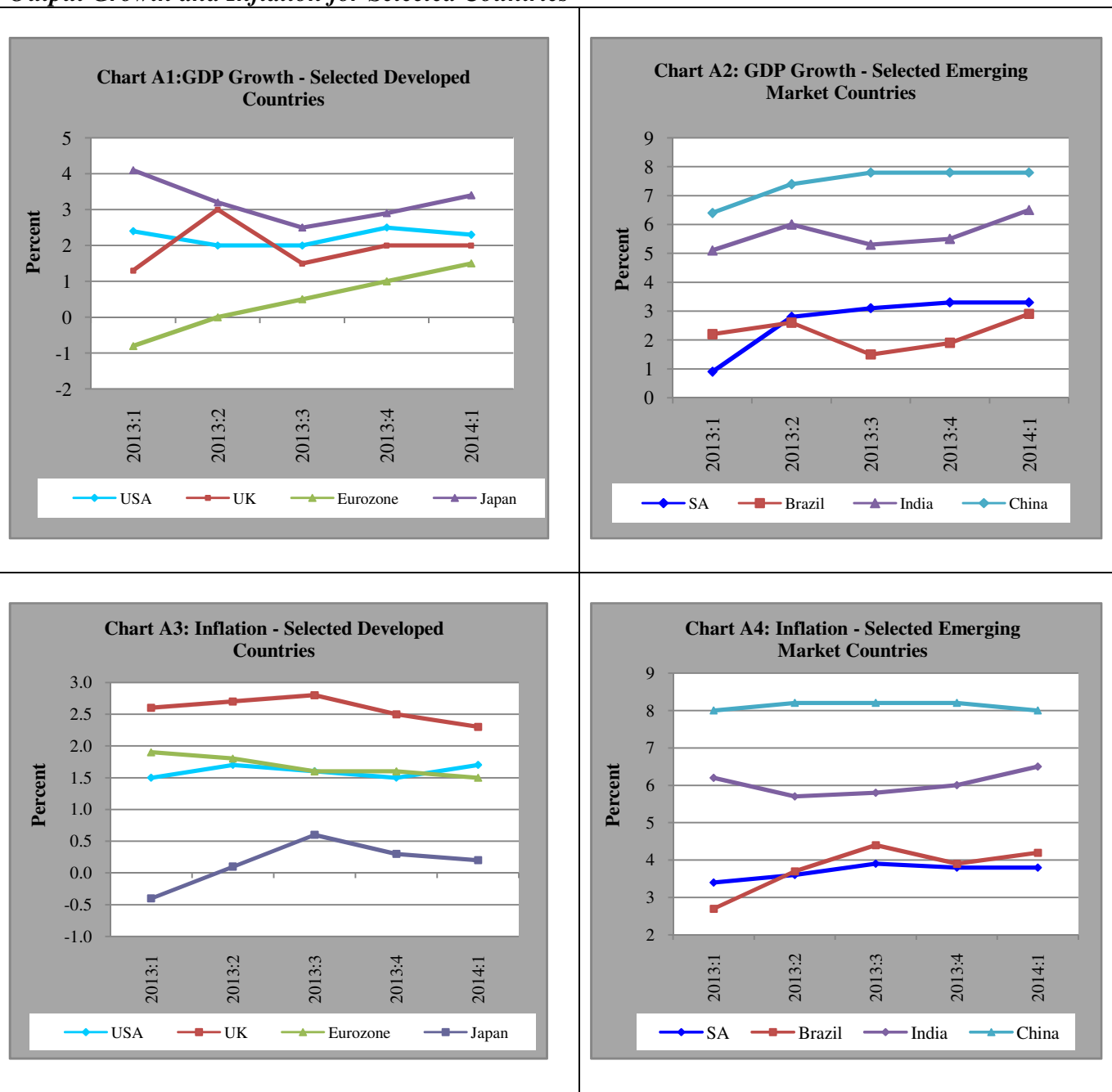
- 6.1 *In line with the forward-looking policy framework, the Bank's monetary policy response takes into account the likely impact of economic activity and associated demand on future price developments (inflation forecast). Below-trend economic performance (negative output gap) is associated with reduced or low pressure on inflation and could signify a need to provide monetary policy stimulus to support economic growth, while economic activity that is above trend is likely to result in an increase in inflation and could require monetary policy tightening to restrain inflation.*
- 6.2 *It is expected that economic growth will be below trend in the medium term, as influenced by slowing global economic expansion and low growth in government spending and incomes. Against this background, it is expected that inflation will remain within the 3 – 6 percent objective range in the second half of 2013.*
- 6.3 *In assessing the monetary policy stance, the Bank also considers developments in real interest rates and real exchange rates that define monetary conditions in the economy, which ultimately have an impact on domestic demand. Real monetary conditions were tight, although less so in the first quarter of 2013, largely due to real exchange rate developments, but this was partially offset by the reduction in nominal interest rates. Looking ahead, the real exchange rate and real interest rate gaps suggest maintenance of relatively tight real monetary conditions in the medium term (Chart 8).*
- 6.4 *Therefore, the current state of the economy and the projected performance, together with the positive inflation outlook, suggest that maintaining the existing monetary policy stance is consistent with the attainment of the 3 – 6 percent inflation objective in the medium term. As such, monetary policy will be supportive of economic activity in an environment where the impact of the expansionary fiscal policy is limited by restrained government spending. Due to the projected stable and modest inflation differential between Botswana and her trading partner countries, the 0.16 percent downward crawl will be maintained for 2013.*

¹⁹ *As reported in the BES, businesses expect inflation to remain above the objective range, and this is reflective of continuing concerns about the possible increase in input costs.*

7. SUMMARY AND CONCLUSION

- 7.1 *Inflation trended downwards in the first half of 2013, although it was above the objective range of 3 – 6 percent for much of the period. It fell into the objective range in June 2013 (5.8 percent). The fall in inflation was influenced by base effects associated with the increase in administered prices in the first half of 2012, as well as the moderation in the annual change in cost of some categories of goods and services in the first half of 2013. Meanwhile, domestic demand and external inflationary pressures remained low. The Bank Rate was cut from 9.5 percent to 8.5 percent in the first half of 2013, to support economic growth, in the context of the positive medium-term outlook for price developments.*
- 7.2 *Looking ahead, it is anticipated that external price pressures on domestic inflation will be benign given the projected moderate expansion in world economic activity, stable commodity prices and the dampening impact of the partial capacity utilisation and high rates of unemployment in major economies. In the domestic economy, slow increase in incomes and below-trend performance of the economy are expected to moderate demand pressures on inflation. Risks to the inflation outlook stem from any possible large adjustment to administered prices and government levies, as well as any increase in international food and oil prices beyond current forecasts.*
- 7.3 *Accordingly, an accommodative monetary policy stance is consistent with the achievement of the 3 – 6 percent inflation objective in the medium term and remains appropriate for supporting stronger economic expansion. The Bank will continue to monitor economic and financial developments with a view to responding appropriately to ensure price stability in the medium term, without undermining economic activity and growth.*

Output Growth and Inflation for Selected Countries



Source: JP Morgan Chase

Note: Data from 2013Q3 to 2014Q1 are forecasts