



**MONETARY POLICY STATEMENT  
2010  
MID-TERM REVIEW**

*August 2010*

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## **1. Introduction**

- 1.1 *The Mid-Term Review (MTR) of the 2010 Monetary Policy Statement (MPS) assesses progress made in the first half of the year towards maintaining inflation within the 3 – 6 percent objective range. The review also reappraises developments in key financial and economic conditions that will affect the inflation outlook and the corresponding monetary policy responses during the remaining period of the year and, in the medium-term, in order to maintain price stability. The Bank's communication of the Mid-Term Review of the inflation outlook and the prospective monetary policy stance fosters public expectations of low, sustainable and predictable inflation.*
- 1.2 *The 3 – 6 percent inflation objective range represents the Bank's definition of price stability in the context of the Botswana economy. Inflation within this range is considered low and consistent with sustainable long-run growth of the economy. Moreover, low inflation that is close to that prevailing in trading partner countries contributes to the stability of the real effective exchange rate (REER) which, in turn, fosters international price competitiveness of domestic producers.*
- 1.3 *As anticipated at the beginning of this year, the economy began to recover during the first quarter although the overall level of domestic economic activity was below trend, a factor that exerted low demand pressures on inflation. Price developments were also in line with the projections, with inflation rising in the first half of 2010, from 5.8 percent in December 2009 to 7.7 percent in June 2010<sup>1</sup>, due to the increase in value added tax (VAT), as well as electricity tariffs and fuel prices. The positive medium-term inflation outlook was nevertheless maintained; hence, the Bank Rate was unchanged in the first half of 2010, following a 100 basis point reduction in December 2009. Looking ahead, inflation is expected to remain above the objective range in the short-term, but should be within the objective range in the first half of 2011, assuming there is no substantial increase in administered prices and government levies.*
- 1.4 *The global economy is expected to continue on the recovery path, albeit tentatively with significant downside risks. In particular, there could be moderation in prospective growth in the short term due to implementation of strengthened financial sector supervisory framework and fiscal consolidation that is aimed at ensuring long-term fiscal and debt sustainability in some of the major economies. For 2010, world output is projected to increase by 4.6 percent (compared to -0.6 percent in 2009), due mostly to strong growth in Asia, while slower growth of 4.3 percent is forecast for 2011.*

## **2. Monetary Policy Framework**

- 2.1 *Monetary policy is conducted to attain price stability in the economy which, in the Bank's case, is defined as inflation in the range of 3 – 6 percent. A low and predictable level of inflation contributes to sustainable economic growth and development by promoting savings mobilisation, productive investment and international competitiveness of domestic producers of goods and services. A sustained rise in inflation (and its volatility) is not conducive to economic growth as it discourages financial saving, generates investment uncertainties and quickly erodes the purchasing power of incomes, hence*

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<sup>1</sup> *Inflation subsequently fell to 7 percent in July, thus reflecting a generalised lower rate of price increase across several categories of goods and services.*

*reducing living standards. Similarly a prolonged period of low inflation or rapidly falling inflation signals a decline in economic performance, which could require monetary policy easing to stimulate growth.*

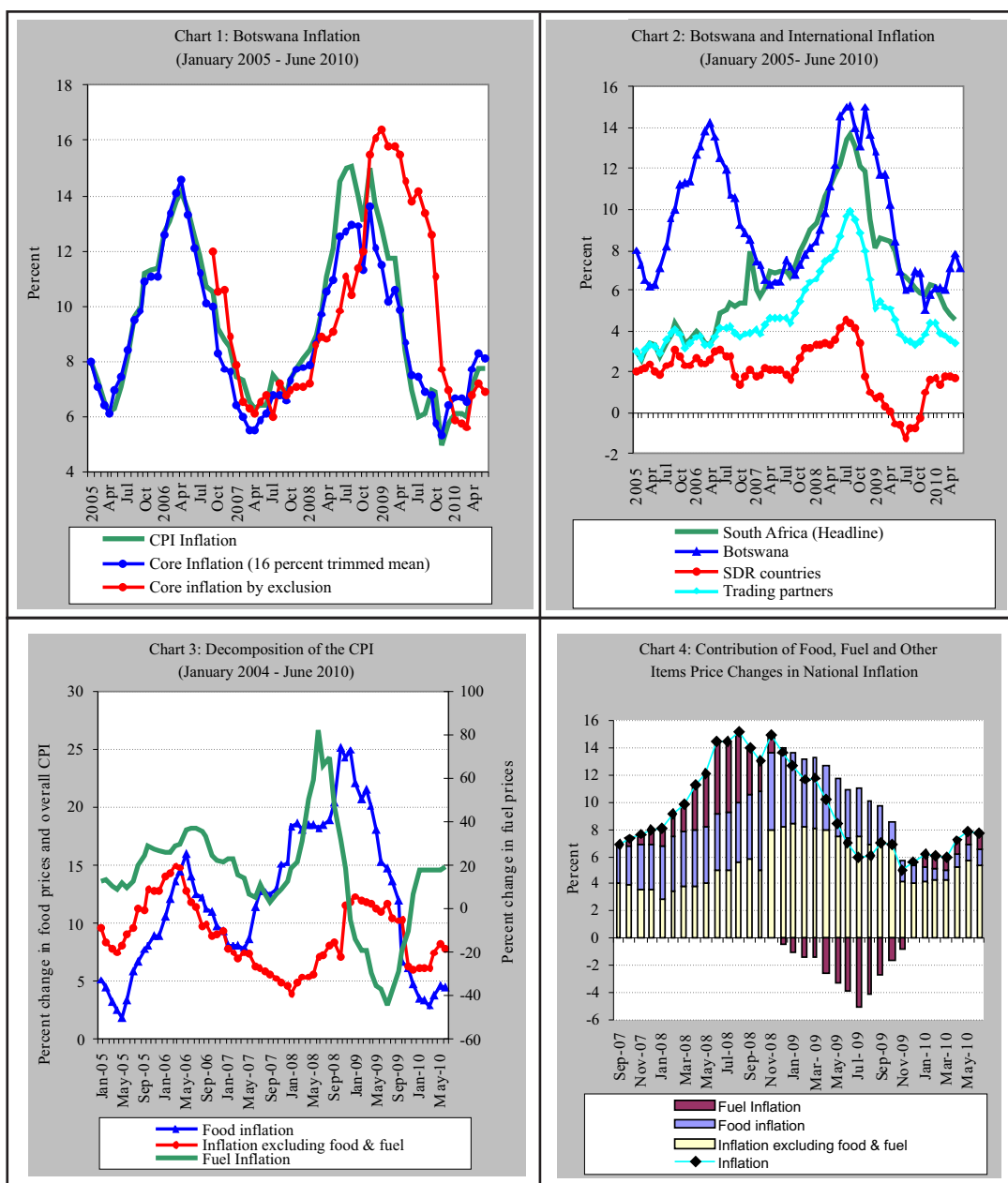
- 2.2 The Bank's policy framework entails a forecast-based, and thereby forward-looking, monetary policy strategy focused on the medium-term. The medium-term, which is a three-year rolling period, is considered a reasonable time frame over which monetary policy can affect price developments. The forecast for inflation is derived from an assessment of prospective developments for the various determinants of inflation, including domestic demand conditions, changes in prices of imports and exchange rates, adjustment of administered prices and consumption taxes, as well as public expectations with respect to the rate of price changes.*
- 2.3 The Bank uses interest rates and open market operations to influence demand (relative to supply capacity) and, ultimately, price developments in the direction consistent with price stability. In this respect, the policy response to inflationary pressures is based on an evaluation of the sources of inflation and the likely impact on future price developments. In particular, a distinction is made between factors with a transitory impact<sup>2</sup>, such as changes in administered prices and consumption taxes, and those that are likely to have an enduring influence on inflation such as changes in demand conditions, which are subject to monetary policy influence. This approach to policy formulation facilitates appropriate and timely responses to any sustained deviation of inflation from the objective. In addition, the alternative measures of inflation, including headline inflation, 16 percent trimmed mean and inflation excluding administered prices, play an important role in explaining the sources of inflation.*
- 2.4 Operationally, the Monetary Policy Committee meets approximately every two months. The Committee reviews inflation forecasts and the monetary policy stance in order to evaluate current and prospective changes in economic developments that influence the outlook for the determinants of inflation. The bi-monthly meetings and review enable timely response to anticipated economic and other events that would result in a significant and lasting deviation of inflation from the objective range.*
- 2.5 An important benefit of achieving the inflation objective is the contribution to stabilisation of the real effective exchange rate (REER), which supports international competitiveness of domestic industries. In the event that the inflation objective remains higher than forecast inflation of trading partner countries, the crawling band exchange rate arrangement facilitates a continuous non-inflationary downward adjustment of the nominal effective exchange rate in order to maintain stability of the REER.*
- 2.6 The Bank's monetary policy framework and its implementation are regularly communicated to the public through the launching and publication of the annual Monetary Policy Statement, dissemination of the Mid-term Review of the Monetary Policy Statement, and Press Releases following Monetary Policy Committee meetings. This communication fosters policy transparency, accountability and credibility. It also enhances the degree to which the Bank may succeed in influencing expectations of price stability.*

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<sup>2</sup> Policy does not normally respond to these transitory factors since the medium-term is the relevant time frame for monetary policy to have an effect on prices.

### 3 Inflation in the first half of 2010

3.1 Average inflation in trading partner countries trended downwards and declined from 4.4 percent in December 2009 to 3 percent in June 2010, against the background of low levels of capacity utilisation, weak labour markets and well-anchored inflation expectations. In South Africa, headline inflation, which is the target measure for the South African Reserve Bank (SARB), eased from 6.3 percent in December 2009 to 4.2 percent in June 2010, mainly as a result of lower rates of increase in food prices. Therefore, inflation in South Africa was within the target range of 3 – 6 percent in the first half of 2010 except for January. For the SDR<sup>3</sup> countries, average inflation eased from 1.6 percent to 1.3 percent in the same period.



Source: Bank of Botswana

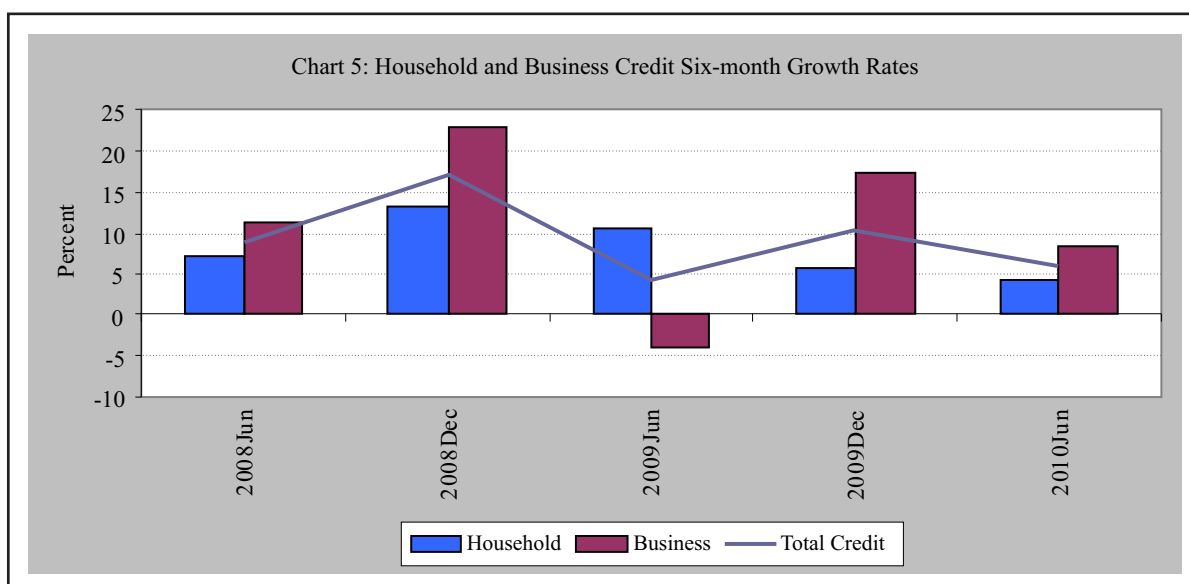
3 The Special Drawing Rights (SDR) is a monetary unit of account of the International Monetary Fund (IMF) calculated as a weighted average of the exchange rates of the United States dollar, the Euro, the British pound sterling and Japanese yen.

- 3.2 *Domestic inflation was stable around 6 percent in the first quarter of 2010, but accelerated to an average of 7.5 percent in the second quarter due to the increase in value added tax (from 10 percent to 12 percent effective April), the average 30 percent increase in electricity tariffs and increase in fuel prices in May. These changes contributed about three percentage points directly to inflation in the second quarter of the year.<sup>4</sup> Overall, inflation rose from 5.8 percent in December 2009 to 7.8 percent in May 2010, before easing slightly to 7.7 percent in June, thus remaining above the Bank's 3 – 6 percent inflation objective range. Similarly, the 16 percent trimmed mean measure of core inflation accelerated from 6.4 percent to 8.1 percent in the first half of 2010. Conversely, core inflation excluding administered prices fell from 7 percent to 6.9 percent in the same period, given the absence of the impact of changes in administered prices in this measure.*
- 3.3 *Among the administered prices, the downward trend in the rate of increase in fuel prices that was experienced in 2009 was reversed in the first half of 2010 (Chart 3). Notably, the annual change in the cost of fuel accelerated from 6.3 percent in December 2009 to 18.8 percent in June 2010, mainly due to the impact of the May 2010 increase in prices. However, for market-determined prices, the rate of increase in food prices continues to be moderate, falling from 4.7 percent in December 2009 to 4.5 percent in June 2010.*
- 3.4 *By tradeability, imported tradeables inflation accelerated from 6 percent in December 2009 to 10.3 percent in June 2010, partly reflecting the higher cost of fuel. Inflation for domestic tradeables also increased from the 1.9 percent in December 2009 to 4.2 percent in June 2010 in the same period. Overall, the all tradeables inflation rose significantly from 5.1 percent to 7.9 percent. For non-tradeables, the year-on-year increase in prices fell from 8.5 percent in December 2009 to 7.3 percent in June 2010, which was attributable to lower annual rates of increase with respect to rentals, primary school fees and medical charges.*
- 3.5 *Domestic demand pressures on inflation were moderate due to restrained growth in government expenditure and disposable incomes (given the wage freeze for the public service and the increase in VAT and administered prices) and the associated modest monetary expansion. After a 3.7 percent contraction in 2009, economic recovery that was evident from the fourth quarter of 2009 (a 10.7 percent quarter-on-quarter increase in GDP) was maintained in the early part of 2010, with output in the first quarter of 2010 being 36.4 percent larger than in the first quarter of 2009. The overall substantial expansion in output is mostly due to the 1.4 times increase in mining output in the first quarter of 2010, following recovery of the diamond export market. Non-mining sector output rose by 8.2 percent in the same period, supported by strong production by the agriculture (70.6 percent), water and electricity (21.8 percent), and trade, hotels and restaurants (6.6 percent) sectors.*

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4 *It is estimated that the initial impact of the increase in VAT raised the price level by about 1.7 percentage points, while the direct effect of the increase in electricity tariffs and fuel prices were 0.5 and 0.7 percentage points, respectively. However, the effect of the fuel price increase (recorded in the June CPI) did not result in an increase in inflation (in June) as it was offset by the impact of the increase in the cost of fuel of June 2009 dropping out of the inflation calculation.*

3.6 *An indication of economic recovery is also apparent from the faster rate of increase in commercial bank credit, which rose by 5.9 percent in the first six months of 2010 compared to the 4.4 percent for the corresponding period in 2009 (Chart 5). In particular, lending to businesses grew by 8.3 percent in the first half of 2010, after contracting by 4.1 percent in the same period in 2009. However, growth in household borrowing decelerated from 10.6 percent to 4.3 percent in the same period. In the year to June 2010, credit expansion was 17 percent lower than the 22.3 percent for the twelve months to June 2009. Although improving, credit developments reflect a cautious lending approach by banks and restrained borrowing due to economic uncertainty and the limited upward income effect on household credit demand in the absence of an across-the-board wage increase for civil servants, which would normally be replicated by other employers. Money supply, which had fallen continuously from September 2009, resumed growth in January 2010 and registered annual growth of 6.2 percent in May 2010. In addition to the faster rate of credit expansion, the growth in money supply is influenced by reduction in the pace of decrease in net foreign assets and fall in government deposits at the Bank of Botswana.*



Source: Bank of Botswana

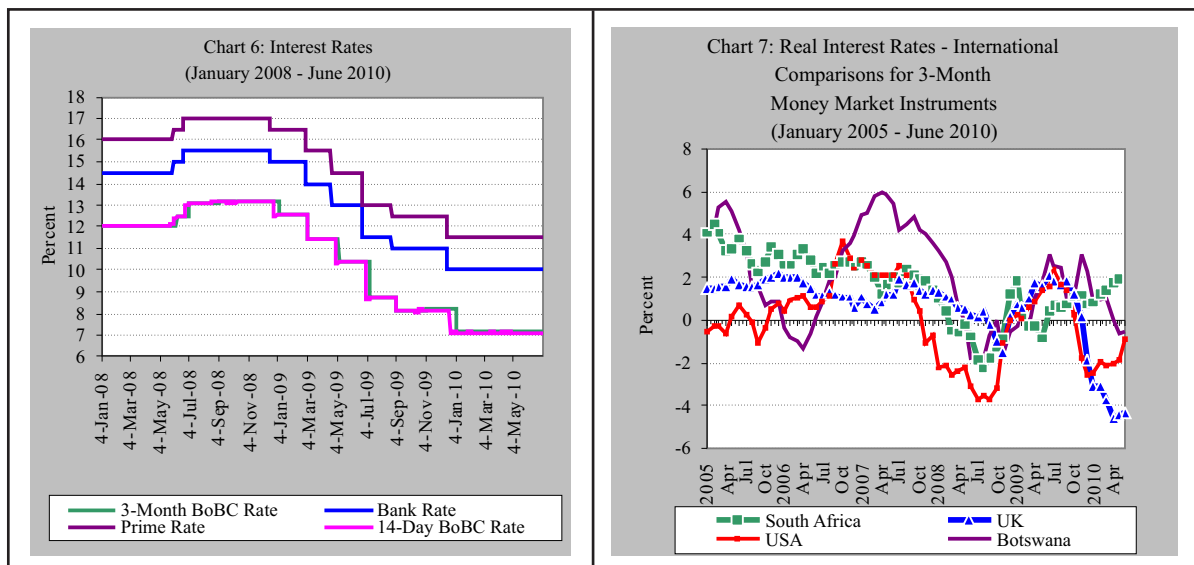
3.7 *The fall in government deposits at the Bank of Botswana is a reflection of the budget deficit position that had to be financed by a drawdown of accumulated government savings. Although Government spending increased at a much slower rate than during the comparable period the previous year, fiscal policy was, nevertheless, counter-cyclical. Thus, the increase in total recurrent and development spending in the twelve months to March 2010 was 8.3 percent, and much lower than the 41 percent for the corresponding period in 2009, and 15.5 percent revised estimate announced in the February 2010 Budget Speech (the original budget was for an increase of 5.3 percent). Development expenditure expanded by 13.1 percent in the fiscal year ending March 2010, while recurrent spending rose by 5.9 percent. Meanwhile, a 3.7 percent decrease in total government spending is budgeted for 2010/11, including a substantial 15.7 percent decline in development expenditure. With the continuing cash flow constraints, the Government has announced a prioritisation of project spending, tightening of budget management and implementation of measures to raise revenue, including the increase in the rate of VAT (effective April 2010) and government levies, as well as drawing dividends from parastatals. It is anticipated that the P12.1 billion budget deficit for*

2010/11 will be financed by a combination of domestic borrowing and drawdown of accumulated savings. While desirable, the expenditure rationalisation will, to some extent, reduce the expansionary effect of government spending on other sectors and the broader economy.

#### 4 Monetary Policy Implementation in the First Half of 2010

4.1 In the first half of 2010, monetary policy was conducted in an environment where there were no changes in the prognosis made at the beginning of the year. Prospects for world economic recovery were judged to remain largely positive and contributing to improvement in the domestic economic outlook. However, it was anticipated that domestic output will be below trend in the medium-term, partly reflecting efforts to curtail government expenditure. The benign effect of external price developments on domestic inflation was expected to continue, while domestic demand pressures were to remain low given relatively tight monetary conditions and below-trend output in the medium-term. Nevertheless, the short-term increase in inflation was considered to pose a risk to anchoring expectations of low inflation, and a further increase in administered prices and government levies was anticipated.

4.2 Overall, inflation was forecast to stabilise within the objective range in the medium-term; hence, a neutral monetary policy stance was maintained. However, as the rate of price increase was expected to remain above the objective range in the short-term, the Bank underscored the need to restrain inflation expectations. The Bank Rate was, therefore, maintained at 10 percent in the first half of 2010. In response, money market interest rates fluctuated marginally (Chart 6). The average prime lending rate of commercial banks was constant at 11.5 percent between December 2009 and June 2010, while the average 88-day deposit rate fell from 5.79 percent in December 2009 to 5.61 percent in June 2010. The yield on the 14-day BoBC decreased from 7.12 percent at the end of December 2009 to 7.10 percent in June 2010, while the 3-month BoBC yield also eased to 7.15 percent in the same period.



Source: Bank of Botswana

- 4.3 *As a result of the increase in inflation, real interest rates fell and turned negative (Chart 7). The 3-month BoBC real interest rate decreased from 2.27 percent in December 2009 to -0.51 percent in June 2010. Similarly, the real interest rate for the 14-day BoBC fell from 1.25 percent in December 2009 to -0.56 percent in June 2010; and the real prime lending rate eased from 5.39 percent in December 2009 to 3.53 percent in the same period. On the deposit side, the real interest rate on the representative 88-day deposit fell from -0.01 percent to -2.12 percent.*
- 4.4 *Since domestic inflation was higher than the average inflation of trading partner countries, the nominal exchange rate of the Pula crawled downwards and depreciated by 1.4 percent in the six months to June 2010. Bilaterally, the Pula appreciated by 0.1 percent against the SDR (including a 5.5 percent weakening against the US dollar), and depreciated by 2.4 percent against the rand. The real effective exchange rate (REER)<sup>5</sup> of the Pula appreciated by 2 percent in the six months to June 2010 due to the widening of the differential between inflation in Botswana and that of trading partner countries. The appreciation of the REER in this period means that the rate of crawl only partially offset the inflation differential.<sup>6</sup>*
- 4.5 *Movements in interest rates and the Pula exchange rate are reflected in changes in the real monetary conditions index, measuring the relative tightness of financing conditions in the economy. As a result of unchanged interest rates, the moderate increase in domestic inflation and the associated widening of inflation differentials vis-à-vis the average inflation of trading partner countries, real monetary conditions were largely stable, albeit somewhat tight, in the first half of 2010.*

## **5 Inflation Outlook**

- 5.1 *The forecast for inflation entails an assessment of prospective developments of factors that affect domestic price developments, including demand-pull pressures resulting from real economic activity, imported inflation and other exogenous factors, such as changes in administered prices. The external influences on domestic prices comprise economic and financial developments in South Africa, which is Botswana's major trading partner, as well as global events, including changes in international commodity prices and demand in major markets.<sup>7</sup>*
- 5.2 *South Africa's GDP is expected to grow by 2.6 percent in 2010, following a contraction of 1.8 percent in 2009. The main drivers of this forecast expansion are improved prospects in the manufacturing and mining sectors and household consumption expenditure, as well as the impact of the 2010 World Cup. Although inflationary pressures are expected to remain subdued, there are upside risks to the inflation outlook emanating from wage settlements that are above the inflation target and the increase in administered prices. Nevertheless, it is projected that inflation in South Africa will remain within the 3 - 6 percent inflation target range for the whole of 2010 and into the medium-term. In consideration of the balanced risks to the inflation outlook, the South African Reserve Bank is expected to maintain the current monetary policy stance in the short-term.*

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5 *The REER is calculated using Botswana's headline inflation and the weighted average inflation for the SDR countries and South Africa's CPI inflation.*

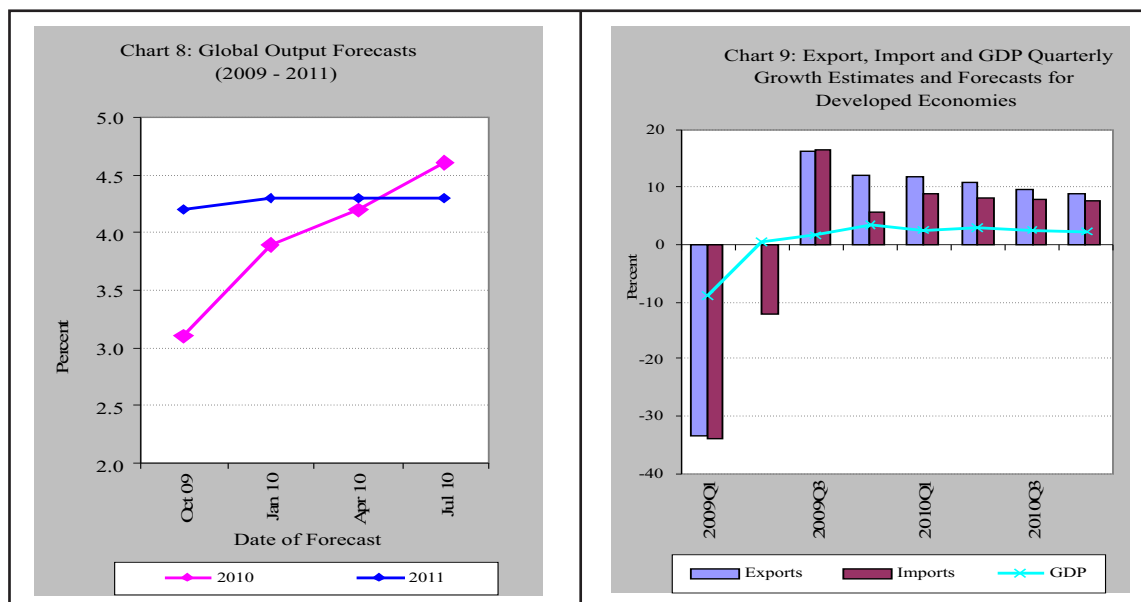
6 *The difference in inflation rates, however, is due to the influence of transitory factors, such as the increase in VAT and administered prices in Botswana.*

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



5.3 *World economic recovery is on track and global output is forecast to grow by 4.6 percent in 2010, from a contraction of 0.6 percent in the previous year, before slowing slightly to 4.3 percent in 2011 (Charts 8 and 9). The significant improvement in forecast global economic activity in 2010 is attributable mostly to the positive impact of the stimulus packages on both business and consumer confidence. However, prospective growth in 2011 could be moderated by the impact of fiscal consolidation in some major economies that is aimed at ensuring long-term fiscal and debt sustainability. Growth could also be lower in the short-term as a result of implementation of enhanced financial sector supervisory measures that seek to foster financial stability and mitigate potential for interruptions to financial flows, in support of economic activity. Overall the forecast for robust world economic growth will depend on strong performance in emerging market economies.*

5.4 *The improvement in world economic performance is also expected to contribute to recovery of commodity prices; hence the risk for an increase in inflationary pressures. However, the rate of increase in prices is restrained, with global inflation forecast at 3.4 percent for 2010 and 2.9 percent for 2011. Average inflation in SDR countries is forecast at 1.2 percent in 2010 and 1.5 percent in 2011. The risks to the world inflation outlook include uncertainty surrounding developments in international oil prices which, so far, have been fluctuating within a narrow range. More recently, there is an upside risk to food inflation due to likely food shortages caused by unfavourable climatic conditions.<sup>8</sup> With respect to policy, monetary stimulus remained in place in the major economies. However, interest rates are being increased in other countries in the context of emerging inflationary pressures, especially in emerging market economies that are experiencing robust growth. On the fiscal side, several European countries have started implementing expenditure reducing and revenue raising measures.*



Source: JP Morgan, World Economic Outlook, Various Editions (International Monetary Fund)

- Note: 1. Developed economies include USA, UK, Euro area, Japan, Norway, Canada, Australia, Sweden, New Zealand and Switzerland  
 2. Data for 2009Q1 – 2010Q1 are estimates, while for 2010Q2– 2010Q4 are projections

8 For example, the announcement in early August by Russia to ban export of wheat for the remainder of 2010, while drought has also constrained production in other countries.

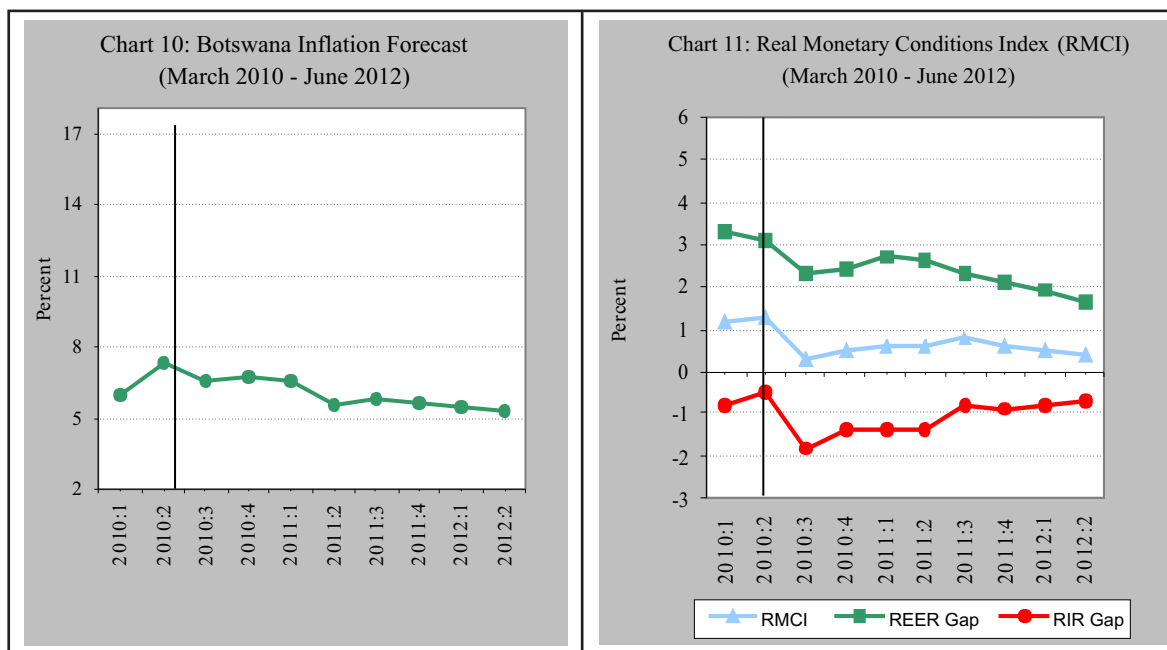
- 5.5 *The recovery in the domestic economy that is evident from developments in the first quarter of 2010 is expected to be sustained going forward, mostly buoyed by improvement in external demand. In addition, the March 2010 Business Expectations Survey (BES) showed an improvement in business confidence (from 47 percent in the September 2009 survey to 55 percent) and higher expectations of economic recovery. Output is, nevertheless, projected to be below-trend in the medium-term, in part reflecting the impact of reduction in government expenditure on the non-mining sectors. Moreover, consumption and its contribution to domestic demand and output expansion will be constrained by the slow growth in disposable incomes.*
- 5.6 *The narrow inflation differential between Botswana and her trading partner countries means that a modest and non-inflationary rate of crawl will continue throughout 2010. Bilateral exchange rate movements are also largely offsetting and, therefore, expected to have a minimal influence on domestic price developments. Furthermore, inflation is restrained in South Africa and SDR countries. The upside risks to the domestic inflation outlook include a possible large increase in administered prices and government levies. Overall, the Bank forecasts that inflation will remain above the objective range in the short-term, but fall within the range in the second quarter of 2011 (Chart 10).*

## **6 Monetary Policy Stance**

- 6.1 *In line with the forward-looking, forecast-based framework, the Bank's monetary policy stance is predicated on an assessment of prospective medium-term economic performance, relative to the long-term trend. Hence, the policy response takes into account the likely impact of economic activity and associated demand on future price developments. Below-trend economic performance implies 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 policy tightening to dampen inflation.*
- 6.2 *It is anticipated that output will be below trend in the medium-term. Although the exporting sectors will benefit from sustained recovery in world demand, domestic economic growth will be moderated due to reduced government spending. Furthermore, it is expected that demand and its impact on economic activity will be subdued as a result of the public sector wage freeze, together with the increase in VAT, administered prices and other levies. Therefore, in the absence of the transitory impact of the increase in VAT and administered prices, domestic inflation would be within the 3 – 6 percent objective range.*
- 6.3 *Monetary policy stance is also assessed with respect to developments in real interest rates and real exchange rates that generate real monetary conditions in the economy, which ultimately have an impact on domestic demand. Due to stable real monetary conditions, a neutral monetary policy stance maintained in the first half of the year was appropriate. The expected developments in the real exchange rate and real interest rates, suggest a slight easing of real monetary conditions in the short-term, but the trend going forward suggests that monetary policy remains neutral in the medium-term (Chart 11).<sup>9</sup> Overall, the current state of the economy and the assumptions regarding both the*

<sup>9</sup> *Real monetary conditions measure the relative tightness or otherwise of monetary policy by gauging the effect of monetary policy on the economy through changes in the exchange rate and interest rates. The real monetary conditions are measured by an index (RMCI) that combines, through a weighted average, the deviations of the real exchange rate and real interest rate from their trend values. Meanwhile, a positive change in the REER indicates appreciation of the Pula against the basket of currencies comprising the rand and SDR in real terms.*

domestic and external economic outlook, along with the inflation forecast, suggest that the prevailing monetary policy stance is consistent with the achievement of the 3 – 6 percent inflation objective in the medium-term. This policy stance could, however, change in response to indications that any expectations of high inflation are becoming entrenched. While inflation is likely to remain above the objective range up to the first half of 2011, this is due to transitory factors. If these are excluded, inflation would be within the objective range.



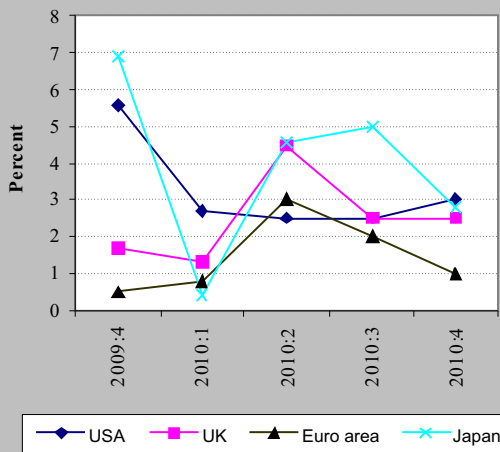
Source: Bank of Botswana

## 7. Summary and Conclusions

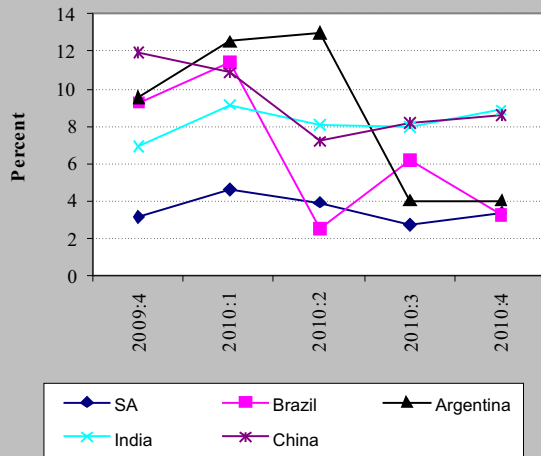
- 7.1 Inflation rose in the first six months of 2010, thus reversing the downward trend that started in the second half of 2009, due to the increase in electricity tariffs, VAT and fuel prices. Domestic demand pressures remained low, while external inflationary pressures were benign. Although the Bank projected inflation to remain above the 3 – 6 percent objective range in the short-term, the Bank Rate was unchanged between December 2009 and June 2010, given the positive medium-term outlook for price developments.
- 7.2 Looking ahead, it is anticipated that external inflationary pressures would remain low, against the background of low levels of capacity utilisation, high rates of unemployment and well-anchored inflation expectations. Domestically, the reduction in fiscal stimulus, weak growth in incomes and, overall, below-trend economic performance should moderate demand pressures on prices. The risks to inflation include the possible large increase in other administered prices and government levies, and higher inflation expectations arising from the short-term spike in the rate of increase in prices.
- 7.3 Accordingly, the prevailing monetary policy stance is consistent with the achievement of the 3 – 6 percent inflation objective in the medium-term, and remains appropriate for supporting economic recovery, including sustenance of robust performance of the non-mining sectors. The Bank will continue to monitor economic and financial developments with a view to responding appropriately to ensure medium-term price stability without jeopardising the anticipated economic recovery and growth.

# Appendices

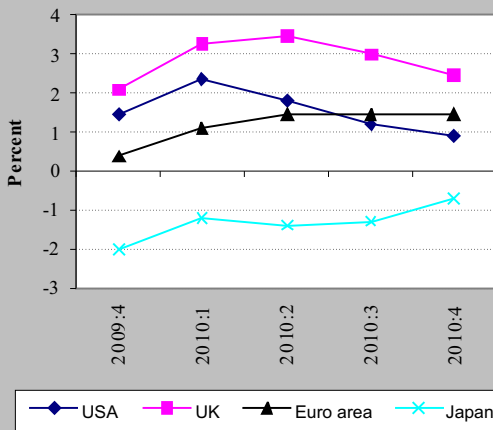
**Chart A1: GDP Growth in Selected Advanced Countries**



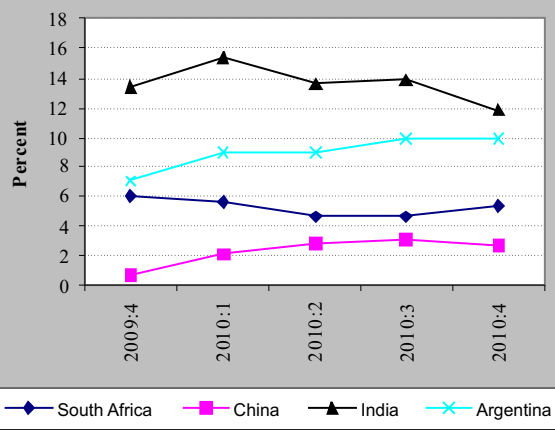
**Chart A2: GDP in Selected Emerging Market Countries**



**Chart A3: Inflation in Selected Advanced Countries**

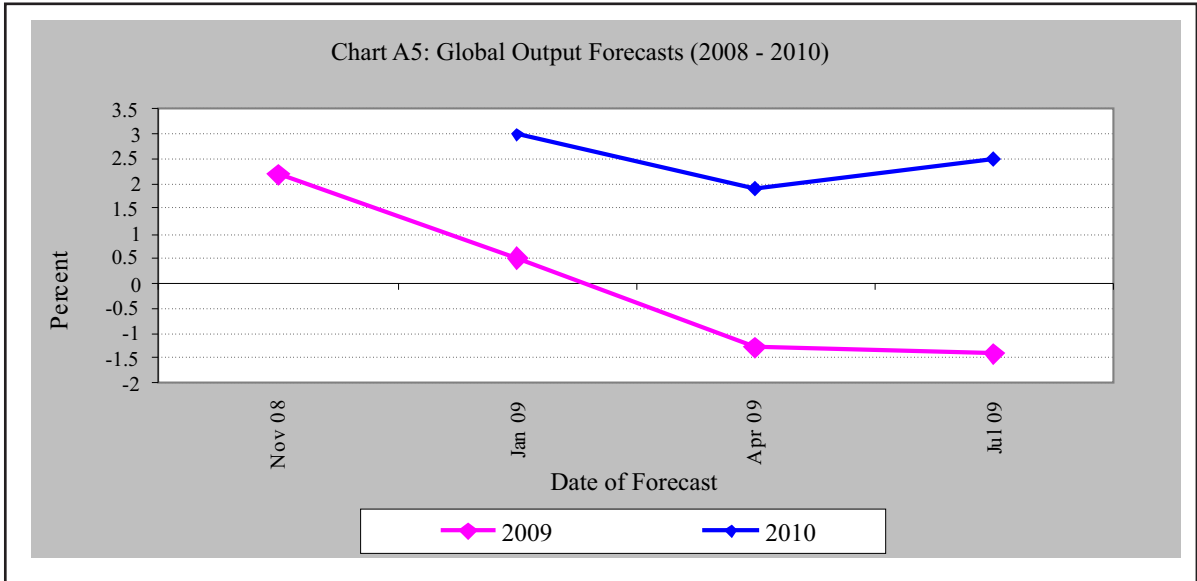


**Chart A4: Inflation in Selected Emerging Market Countries**

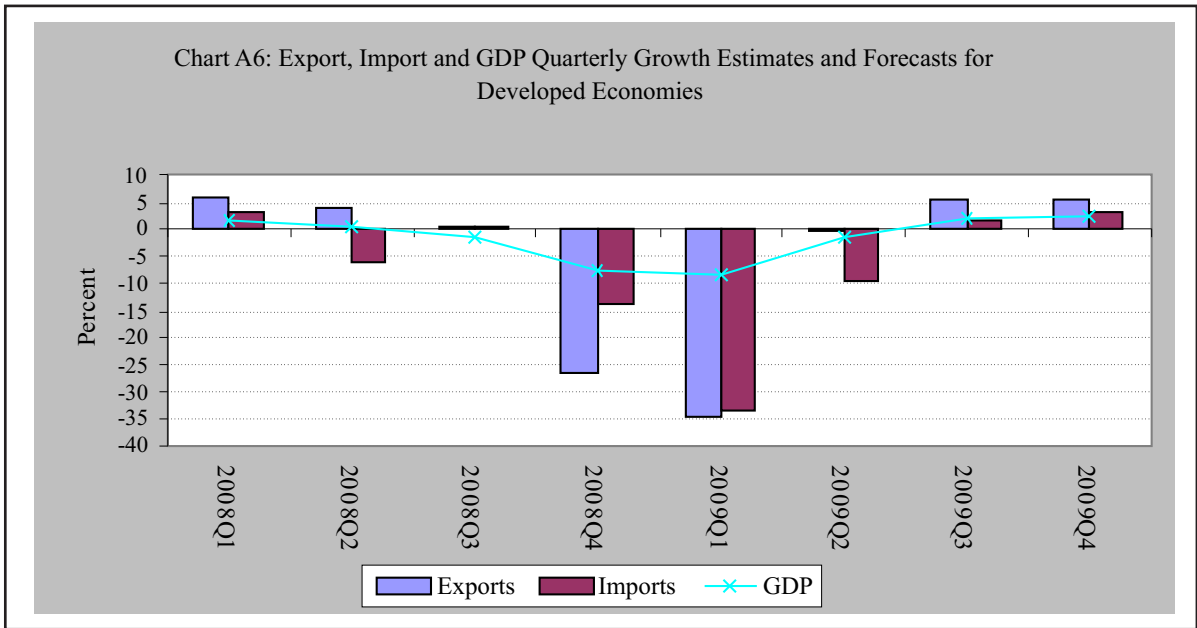


Source: JP Morgan

Note: Data from 2010 Q2 are forecasts



Source: World Economic Outlook, July 2009, International Monetary Fund



Source: JP Morgan