Linah K Mohohlo: 2004 Monetary Policy Statement

Statement by Ms Linah K Mohohlo, Governor of the Bank of Botswana, Gaborone, 17 February 2004.

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Introduction

The 2004 Monetary Policy Statement I am presenting to you tonight is the sixth in a series issued on an annual basis by the Bank of Botswana. The Statement and its mid-year review play a central role in the Bank's efforts to convey to stakeholders and the public at large information on inflation and monetary developments. The Statement also presents an opportunity for the Bank to outline in detail the monetary policy framework, to communicate the annual objective for inflation, and to state the approach that will be taken in formulating the Bank's response to inflation-related developments, so as to ensure that the inflation objective will be met.

In this respect, the Monetary Policy Statement provides an opportunity for the Bank to be transparent, with a view to influence economic and financial expectations of economic agents. The Bank aims specifically to engender an expectation of low and stable inflation, consistent with the broad objective of macroeconomic balance as a basis for sustainable growth in the country.

In line with past practice in delivering the Monetary Policy Statement, I will present only the main highlights, and ask that you find time to read the full Statement, copies of which will be provided shortly, in order to derive its full benefit.

I will begin by briefly reviewing current trends in inflation and their underlying causes, before assessing the extent to which monetary policy succeeded in achieving related objectives in 2003. I will then present the Bank's analysis of the economic and financial factors likely to have a bearing on inflation in Botswana through the year ahead, as a basis for the policy outlook.

The Bank's monetary policy framework and objectives

For a start, I wish to remind you of the Bank's policy objectives and the framework in which they are formulated and pursued. The principal objective of monetary policy in Botswana is the control of inflation, as it is for most central banks. Specifically, it is the achievement of a sustainable low and predictable level of inflation. Precisely how low inflation should be is a matter for debate; what is not debatable (you will concur) is that we have not yet achieved the goal in Botswana. Be that as it may, achieving domestic price stability is not just an end in itself; it is also the means by which the Bank contributes, along with other government policies, to the fundamental objectives of a stable macroeconomic environment and rising incomes and living standards for Botswana.

It is important to point out that this task is not pursued in isolation; it is aimed at supporting other national objectives, such as economic diversification. In broad terms, this means being mindful of the needs of both savers and investors when pursuing the inflation objective, by setting domestic interest rates high enough to provide a positive return to savers but not so high that they discourage private sector investment. It also means taking account of expected inflationary developments in trading partner countries in setting the annual inflation objectives, such that monetary policy will contribute, along with other policies, to maintaining Botswana's international competitiveness. The Bank can do this by seeking to achieve, at a minimum, a rate of inflation that is no higher than the average inflation rate of the major trading partner countries.

Given that the Bank's primary concern is controlling inflation, it is important that the sources of change in the rate of inflation are examined closely, so that the Bank responds only to those changes that are due to domestic demand pressures, and not those that may be due to transitory factors or supply fluctuations over which monetary policy has little or no direct influence. Hence, in addition to the inflation data published by the Central Statistics Office, the Bank examines measures of the underlying inflation trend (core inflation), which exclude the impact of transitory factors and exceptional changes in administered prices or indirect taxes. This is not to suggest that these price developments are ignored. The Bank recognises the need to be prepared to respond, if necessary, to any impact these items might have on underlying inflation through inflation expectations and second-round effects.

Other indicators of progress in meeting the inflation objective include the rate of growth of commercial bank credit to the private sector and changes in government spending. Commercial bank credit is monitored because it is an important contributor to the growth of private consumption and investment and can be directly influenced by monetary policy through interest rates. Government spending is important for monetary policy because of its large contribution to overall domestic demand. It is this continuing large role of the Government in the economy that underscores the need for complementarity between fiscal and monetary policies in achieving the inflation objective.

Domestic inflation trends in 2003

Let me briefly review monetary policy developments and actions undertaken last year, and share with you what the Bank believes is possible for 2004. This will include a comment on the monetary policy implications of the actual and potential developments.

You will recall that in the context of its longer-term objective of low and stable inflation, the Bank's inflation objective for 2003 was 4 - 6 percent. Through this objective, the Bank sought to influence and maintain expectations of sustainable low inflation in an environment of a high risk of a VAT-induced increase in inflationary expectations. Moreover, the Bank considered that aiming for an inflation level lower than what was expected in trading partner countries would help regain some of the competitiveness that was lost in 2002 as a result of higher relative inflation in Botswana.

The external environment was generally supportive of these efforts. Imported inflation fell as global inflation stayed low, while in South Africa inflation declined. Here at home, domestic demand pressures eased as the earlier high rates of credit growth came down and the growth in government expenditure was contained. The combination of low global inflation and reduced domestic demand pressures led to a lower rate of inflation in Botswana as the year progressed, most notably from July onwards, once the effect of VAT on inflation had run its course and began to drop out of the inflation calculation.

VAT had a major impact in the initial 2 - 3 months following its introduction in July 2002. By the end of that year, inflation had risen from the annual rate of 6 percent, where it had been in the months prior to the introduction of the tax, to just over 11 percent. It rose further in the first half of 2003, peaking at an annual rate of 12.2 percent in June; inflation then began to decline as the effect of VAT waned, and demand pressures eased. By December 2003, inflation was almost back to pre-VAT levels, at 6.4 percent - just above the upper end of the Bank's inflation objective of 6 percent. When the impact of VAT is discounted, which the Bank has estimated increased consumer prices by 4 to 5 percent, underlying inflation was slightly above the upper end of the inflation objective for most of 2003.

Monetary policy implementation during 2003

While a major concern for monetary policy in 2003 was to contain the inflationary impact of the introduction of VAT, it was also important that policy continued as much as possible to support the downward trend in underlying inflation that had begun to develop in 2000 and 2001. In the circumstances, monetary policy remained relatively restrictive for much of the year. However, as credit growth slowed and inflation rates declined, as had been expected, and the global inflation outlook remained supportive of continuing low inflation abroad, the Bank took the opportunity to reduce its lending rate (Bank Rate) twice, by 50 basis points in October and by another 50 basis points in December, taking it to 14.25 percent.

These reductions in the Bank Rate were followed by reductions in commercial bank lending and deposit interest rates. Indeed the prime lending rate was reduced in two steps by a full one percentage point to 15.75 percent, to match the reduction in the Bank Rate. Deposit interest rates, on the other hand, were reduced by a lesser amount; for instance, the average 88-day deposit rate fell by 65 basis points to 9.5 percent.

Despite this decline in domestic short-term nominal interest rates, inflation-adjusted (or real) interest rates remained high as inflation declined. By year-end, the real three-month Bank of Botswana Certificate (BoBC) middle rate was 6 percent, and higher than comparable rates in major economies and in South Africa.

The Bank's operations in the money market were conducted during the year to ensure that short-term interest rates, in particular the yield on three-month BoBCs, were consistent with this policy stance.

Market operations were also used to sterilise the large increase in liquidity arising from the continued funding by the Government of the Public Officers Pension Fund. However, the growth in outstanding BoBCs slowed towards the end of 2003, as an increasing volume of funds shifted to government bonds and to offshore markets.

As most of you will know, P2.5 billion worth of government bonds were issued in 2003 with maturities of 2 years, 5 years and 12 years. By the end of the year, the resulting yield curve was downward sloping and all yields had fallen, which was an indication that the market expected that a decrease in inflation would increase the possibility of a further easing of monetary policy.

I have already noted (with some satisfaction, I must say) that inflation in Botswana had fallen by year-end to levels close to the upper end of the Bank's desired range. Inflation in trading partner countries had also declined, even well beyond levels that had been expected earlier in the year. By December 2003, average inflation in trading partner countries was more than 2 percentage points lower than the earlier estimates of between 5.5 percent and 6 percent. As a result, the relatively high inflation in Botswana, compared to that of trading partner countries, meant that there was a further increase through the year in the real effective exchange rate, a development that raised concern that it was contributing to a deterioration of Botswana's international competitiveness and, in turn, undermining diversification efforts.

This is a valid concern, because it is important that Botswana continues to pursue a development policy aimed at diversifying the economy away from its current dependence on relatively few products, especially diamonds. Of course, there are different ways of achieving this policy goal, and while an exchange rate strategy aimed at real exchange rate stability and international competitiveness can be part of whatever approach is taken, it is important not to lose sight of the fact that real and durable competitiveness and diversification must ultimately come from improvements in productivity.

It is in this context that, earlier this month, the Government took the decision to devalue the Pula by 7.5 percent against the basket of currencies to which it is pegged (South African rand, US dollar, Japanese yen, UK pound sterling and euro). For its part, the Bank will continue to pursue a monetary policy that complements this development and I will highlight in a moment the detail of what this means for the Bank's policy stance for 2004. I hasten to emphasise at this point that the most sustainable way to achieve and maintain a competitive real exchange rate is through the maintenance of low and stable inflation, and the Bank's focus on bringing inflation down to low and sustainable levels reflects both the national objective of export-led economic growth and diversification, as well as the Bank's own statutory objective of achieving and maintaining monetary stability.

The outlook for inflation in 2004

Looking ahead, global economic recovery is expected to gather momentum in 2004, with current estimates of world GDP growth moving up to around 4 percent and higher, compared to an estimated range of 2.5 - 2.75 percent for 2003. Global inflation, however, is expected to remain low and may even decline further in the face of continuing excess capacity in major industrial economies. Although oil prices continue to be volatile, they are currently not expected to move much outside OPEC's target price range.

Inflation in South Africa, which is the most important external influence on inflation in Botswana, declined sharply in 2003, with the South African Reserve Bank's target measure of inflation (CPIX) falling within the 3 - 6 percent target for the first time since its inception in 2000. It is expected that inflation in South Africa will remain within the target range for most of 2004 in response to low international inflation and the strength of the rand, although it is uncertain whether the appreciation of the rand that has taken place recently will be sustained in 2004.

Despite this relatively supportive external environment, it is a fact that Botswana's import prices will rise because of the recent devaluation of the Pula. The timing and extent of the rise will depend on how much and how quickly importers adjust to the higher costs of their products. On the basis of the proportion of imports in the consumer price index, it is estimated that higher import costs could directly add up to 4 percentage points to inflation over the next 6-12 months, in the absence of any offsetting declines in inflation elsewhere in the economy. There is also a danger that traders could exploit the devaluation by raising prices across a range of goods and services by more than is justified by the change in import costs, although this will be constrained to the extent that competition is effective.

Against this background, prospects are mixed. Domestic demand pressures, as indicated by the growth of commercial bank credit and government expenditure, were lower in 2003, and the budget for the 2004/05 fiscal year projects a welcome further reduction in spending growth. It remains to be seen, however, whether this will be sufficient to offset the demand effects of the pickup in credit growth likely to result from the 15 percent average wage increase for the public sector, which may spread to the broader economy as private businesses concomitantly adjust their wage levels. Another risk to the outlook for domestic inflation is the stronger expectations of higher future inflation that the devaluation will engender. However, this year's increases in administered prices are not expected to exceed average underlying inflation and this should mitigate the impact on the overall price level.

In the circumstances, it is possible that, despite the effects of the devaluation on imported inflation, the more positive environment I have noted will prevail during the first half of the year, thus offsetting the initial inflationary impact of the devaluation. Beyond this period, the balance of risks is much less favourable. While the global impact on domestic prices is likely to be benign, the impact of the devaluation on import prices will feed through to prices of domestically produced goods and services. Furthermore, there is uncertainty with respect to the value of the rand, a depreciation of which may lead to an increase in inflation regionally. Domestically, acceleration in the rate of credit growth outside the range consistent with the Bank's inflation objective is likely, given the imminent increase in civil service salaries and a consequent similar action by the private sector. However, the impact of the likely credit expansion on domestic demand will be mitigated to some extent if the rate of growth of government expenditure does not increase by more than the forecast 5 - 6 percent contained in the 2004/05 fiscal year budget, and businesses take measures to offset any possible wage rises.

Monetary policy stance in 2004

All of these factors must be considered when setting the monetary policy objective for 2004. Importantly, in order to achieve a level of inflation that will contribute to maintaining relative stability in the real effective exchange rate, the objective for the year must reflect expectations of inflation for trading partner countries. The forecast inflation for these countries this year is lower than the 2003 estimate that was used to establish last year's inflation objective of 4 - 6 percent. This implies a need for the Bank to lower its 2004 inflation objective in order to meet the goal of a stable real effective exchange rate. You will agree that it would be unrealistic and costly, in terms of output and employment, for the Bank to try and counter the full inflationary fall-out of the devaluation completely over too short a period of time. It will be necessary, as a result, to accept some of the direct rise in inflation from higher import costs, while focusing on preventing these costs from spilling into underlying inflation and into inflation expectations.

To accommodate all these considerations, the Bank has concluded that an inflation objective of 4 - 7 percent during 2004 is appropriate. This will allow room and time for the economy to adjust to the higher imported inflation arising from the devaluation, while ensuring that the potential gain in competitiveness will not be eroded by higher inflation.

The widening of the range (in an upward direction) should not be seen as a loosening of monetary policy. If anything, it implies the contrary, since it only allows overall inflation to rise by about 1 percentage point as a result of the recent devaluation of the Pula, notwithstanding the fact that import prices are likely to rise by significantly more than this amount. The key task for monetary policy, given this inflation objective, will be to prevent these import price increases from feeding through to the prices of domestically produced goods and services. Inflation for these commodities will have to be significantly lower than it would have been without the devaluation.

Without a relatively tight monetary policy stance, there is a real danger that inflation will rise, driven by higher import prices and inflation expectations, to the point where the initial benefits to international competitiveness resulting from the devaluation would be dissipated. It is essential that this is avoided if the potential benefits of devaluation are to be realised. In this regard, it will help as well if other policies that affect aggregate demand are tightened to help keep demand-related inflationary pressures in check. As I have already noted, the Government's budget for 2004/05 goes some way in this direction by limiting expenditure growth. Restraint by parastatals in raising their prices would further help moderate inflationary pressures that arise from such administered price increases.

As I indicated earlier, the Bank's principal intermediate target is the rate of growth of bank credit to the private sector, which is an important contributor to the growth of consumption and investment, and hence to aggregate demand. A desired range for credit growth is specified in order to facilitate keeping

it at levels that are consistent with the Bank's inflation objective. The range for the growth rate of commercial bank credit that is considered to be compatible with achieving the 2004 inflation objective of 4 - 7 percent is 12 - 15 percent. This range is derived from the Bank's expectation of the rate of growth of the non-mining sector of the economy (aggregate supply), and the desired inflation for the year, with an allowance for the process of financial deepening as the economy develops.

Conclusion

I wish to conclude by underscoring the fact that this year's inflation target of 4 - 7 percent will prove to be challenging. As you know, the path to price stability is neither smooth nor easy, and the Bank's inflation objectives need to take this into account. The raising of the upper end of the range in 2004 is a short-term tactical measure in response to a specific set of factors relating to inflation in 2004. The expectation is that future inflation objectives will again relate directly to expected trading partner inflation rates, in order to ensure real exchange rate stability and the Bank's longer term objective of low and stable inflation.

Against the background of the recent devaluation, it will be difficult to ensure that the downward trend in inflation that occurred in the second half of 2003 is sustained throughout 2004, but I can assure you that the Bank will conduct monetary policy with the objective of ensuring that inflation falls within the desired range of 4 - 7 percent by the end of 2004. The Bank remains committed to respond as necessary and appropriately to monetary and inflation developments, in particular to any deviation of credit and government spending growth from levels that are consistent with the inflation objective.

I thank you for both your patience and attention.