Linah K Mohohlo: 2010 Monetary Policy Statement

Speech by Mrs Linah K Mohohlo, Governor of the Bank of Botswana, at the launch of the Monetary Policy Statement for 2010, Gaborone, 25 February 2010.

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Once again, it is my pleasure to welcome you to the launch of the Monetary Policy Statement for 2010. As you are aware, the Statement is the principal means through which the Bank informs the nation and other stakeholders about the monetary policy framework and its implementation. This is done in order to foster policy credibility and anchor public expectations of a low, predictable and sustainable level of inflation. The Statement also reviews current economic trends; it evaluates policy implementation in the past year, and attempts to foresee prospective developments that may influence the inflation outlook. In this way, the validity of the policy framework can be assessed objectively, and the Bank's consequent policy intentions for the coming year can be appreciated.

You will recall that two years ago, the Bank adopted a new forward-looking monetary policy framework which rightly expects policy effectiveness in the medium-term. The framework is based on a model of inflation forecasting which incorporates a wider set of economic indicators. Indeed, with the benefit of continuous technical refinements, the actual domestic inflation has broadly been in line with the model projections.

Before I present the Monetary Policy Statement for 2010, I consider it useful to restate the other core functions of the Bank which, when taken together, provide synergies for monetary policy, for the promotion and maintenance of monetary stability, and for the efficiency of the payments system as well as the soundness of the financial sector.

In addition to the formulation and implementation of monetary policy, the regulation and supervision of banks, is another critical function of the Bank.

The Bank is also responsible for designing, producing and issuing currency, which is a means of payment for transactions and a store of value. Towards this end, you will recall that, in August last year, the Bank launched a new family of banknotes to replace those that had been in use for many years. The banknotes are more fortified against counterfeiting; they update the country's special characteristics and celebrate our heritage.

Yet another key function of the Bank is the management and investment of the foreign exchange reserves, which are a major part of the nation's wealth. Due to the global financial and economic crisis, this particular area of the Bank's responsibilities has recently come under close scrutiny. I wish to take this opportunity, therefore, to reassure the nation that, despite the turmoil in major financial and capital markets, the Bank's prudent investment policy and strategy have served the country well. The purchasing power of the reserves has been maintained and, despite very low export receipts and the high import bill, the reserves remain relatively sizeable at approximately USD9 billion (P59 billion), which is equivalent to 20 months of imports of goods and services.

The Bank is also the banker to the Government and commercial banks, for which it serves as the lender of last resort. In addition, as economic and financial advisor to the Government, the Bank worked very closely with the authorities throughout the year in addressing the challenging external and domestic macroeconomic environment.

Honoured Guests:

I now return to the main agenda of this evening, which is the anticipated direction of the Bank's monetary policy stance during 2010. As I mentioned earlier, the Bank's monetary policy objective is to achieve price stability, as defined by a sustainable, low and predictable level of inflation. This objective is set as a medium-term inflation objective range of 3–6 percent. In order to attain price stability within this parameter, the Bank uses interest rates and open market operations to affect demand and supply conditions in the economy and ultimately the rate of price changes.

You will know that low inflation contributes towards the broader national objective of sustainable economic growth by making saving attractive and investment return predictable, while fostering international competitiveness of domestic producers. In addition, maintaining the purchasing power of money by controlling inflation contributes to the welfare of all economic agents, particularly households.

Apart from interest rates and credit availability, domestic demand and economic activity are also influenced by other factors, especially fiscal policy as well as trade and exchange rate developments. Excessive domestic demand in relation to available goods and services contributes to inflationary pressures; so too do foreign inflation, changes in administered prices (such as government levies and utility tariffs) and public expectations about the future level and direction of inflation.

In its application, however, monetary policy responds to a sustained deviation of the inflation forecast from the objective range in the medium-term. The Bank's responses are based on an assessment of the factors that impact on inflation, including public expectations which could, in turn, be influenced by monetary policy. For example, interest rates would be increased to pre-empt a potential rise in inflation and the consequent erosion of incomes and financial savings. Conversely, the Bank would reduce interest rates in the event of sustained low or rapidly falling inflation. In particular, the Bank's reactions are informed by the performance of the economy in relation to potential output. A sustained level of economic performance above a production trend or potential tends to be inflationary and could suggest the need to raise interest rates to dampen inflationary pressures, while economic performance below output trend could require a reduction of interest rates to stimulate economic activity. However, this policy response is not mechanical; it takes account of expert judgement and supplementary analysis in order to accommodate other factors that may not be fully incorporated in the forecasting model.

At the regular meetings of the Monetary Policy Committee, economic developments and key indicators of the inflation outlook are monitored and reviewed, so that a timely policy response can be taken, if necessary. After each Committee meeting, the decisions, the reasons for those decisions and the inflation outlook are disseminated to the public through press releases. This approach helps to influence inflation expectations and contributes towards fostering policy credibility, which is critical in achieving long-term price stability.

Distinguished Ladies & Gentlemen:

It will come as no surprise to you that this year's Monetary Policy Statement is launched in a substantially different global and domestic macroeconomic environment than was the case last year. Twelve months ago, I had little good news to report. We had foreseen a difficult 2009 due to the unfolding global economic downturn. Botswana's diamond mines had temporarily halted production as the full force of the global recession descended on the country. A substantial portion of my remarks at the time was devoted to assessing the impact of the crisis on the domestic economy. We saw no end to the economic recession, as forecasts for global growth were repeatedly revised downwards. As the year progressed, diamond exports had slowed to a trickle, and impacted negatively on government revenue, the Balance of Payments and the foreign exchange reserves. In the circumstances, work on the tenth National Development Plan had to be postponed so that the budget could be re-worked to ensure the maintenance of long-term fiscal sustainability.

That was then. As we meet today, the picture is considerably more positive, despite uncertainties and challenges posed by the fragile economic recovery in many parts of the world, particularly in Portugal, Ireland, Italy, Greece and Spain (the so called PIIGS). The International Monetary Fund has forecast global output to expand by 3.9 percent this year. This performance reflects the resilience of key emerging economies, and the impact of the stimulus packages that were implemented in most advanced economies.

In fact, the challenge for monetary policy makers in major industrial countries is to design and implement a proper winding down of the stimulus packages that have supported economic recovery, while avoiding generating inflationary pressures. This process will need to be gradual and internationally coordinated within a transparent framework.

Be that as it may, it is recognised that low interest rates and large budget deficits are likely to be maintained during the course of 2010 and beyond. This policy posture is intended to sustain economic recovery that remains sluggish and fragile; it will also help to reduce the risk of the so-called “double dip” recession.

Besides the improved world economic growth, global inflation decreased from 6.3 percent in 2008 to 2.7 percent in 2009. In the four SDR countries – United States of America, Euro zone, Japan and United Kingdom – average inflation was zero. Low inflation was due to a fall in international commodity prices and subdued demand. The resulting low capacity utilisation and high unemployment exerted downward pressure on wages and other prices. In other instances, some developed economies, such as Japan, a fall in prices or deflation is once more a matter of major policy concern.

The overall trade-weighted average inflation of Botswana’s trading partner countries slowed down from 6.1 percent in 2008 to 4.4 percent in December 2009. In South Africa, inflation decreased from 9.5 percent in 2008, and ended 2009 at 6.3 percent, just outside the country’s medium term target range of 3–6 percent.

Here at home, inflation progressively fell in 2009 and was within the 3–6 percent objective range by the middle of the year. In fact, largely due to base effects of earlier price shocks, inflation reached 5 percent in November 2009, the lowest in decades. Thereafter, inflation rose largely due to the winding down of the favourable base effects arising from previous fuel price reductions. By the end of the year, inflation had risen to 5.8 percent, down from 13.7 percent in December 2008, before increasing further to 6.1 percent last month. Both measures of core inflation (the 16 percent trimmed mean measure and the one derived when administered prices are excluded) showed similar sharp declines during 2009; this was additional evidence of the generalised easing of inflationary pressures.

Due to the impact of the global slowdown on demand for diamonds and other minerals, the lower mining production in the first three quarters of 2009 resulted in overall output decreasing by 6.7 percent. In contrast, non-mining output rose by 12.4 percent, reflecting the support extended by the Government’s spending programme, which also contributed to some recovery in business confidence last year.

However, as indicated by significantly low growth rates of commercial bank credit, demand remained subdued for both businesses and households. Households were also affected by generally low wage increases, and a salary freeze for civil servants.

Although the annual growth rate of government expenditure slowed significantly in 2009, it was still higher than initially budgeted. As highlighted in the recent Budget Speech, government expenditure for fiscal year 2009/10 is projected to grow by 15.5 percent compared to the original budget growth rate of 5.3 percent, which to a large extent, reflected the impact of the sizeable supplementary budget that was approved in December 2009.

In order to ease expenditure constraints and finance the larger budget deficit for the fiscal year 2009/10 that is projected at P13.5 billion or 15.1 percent of GDP, the Government borrowed from the African Development Bank and World Bank. A further deficit of a similar magnitude – P12.1 billion or 12.2 percent of GDP – is forecast for the fiscal year 2010/11, and the Government’s objective of restoring fiscal balance, through a combination of robust revenue growth and rigorous expenditure control, is expected in 2012/13.

Honoured Guests:

I wish to emphasise that, while the large deficits in the current economic environment has been appropriate unavoidable and, to a certain extent, affordable, it is essential that the fiscal consolidation required for long-term budget sustainability is achieved going forward. It is urgent that there is increased vigilance in all aspects of macroeconomic management including policy reforms, in order to energise the country's performance in a competitive global environment. This has been underscored by the sovereign credit rating agencies when they recently announced Botswana's relatively intact sovereign credit ratings for 2009 of "A minus" for Standard and Poor's and "A" for Moody's Investors Service. More importantly, despite the marginal downward revision by Standard and Poor's, Botswana's ratings remain firmly in the Investment Grade, and are still the highest in Africa.

It was, however, against the background of lacklustre economic fundamentals that monetary policy was conducted in 2009. In light of the positive inflation outlook and low inflation, the Bank loosened monetary policy throughout the year. The Bank Rate was reduced on five occasions by a cumulative 5 percentage points to 10 percent, and commercial bank lending rates were correspondingly reduced. This policy stance complemented the economic stimulus provided by the Government's expansionary fiscal policy.

Looking ahead, the global economic outlook is projected to improve significantly as more economies continue to emerge from recession. However, as mentioned earlier, economic recovery in developed economies is slow and, in most cases, fragile, while concerns about the build-up of government debt are growing. Furthermore, high unemployment and low growth in household incomes will contribute to weak demand.

In the circumstances, global inflationary pressures are expected to remain low. However, there are risks to the inflation outlook due to uncertainty about international oil and commodity prices that tend to accompany an economic recovery. For this reason, global inflation is forecast to increase from 2.7 percent in 2009 to 3.8 percent in 2010, while inflation in SDR countries is expected to increase from zero in 2009 to 1.5 percent this year. In contrast, South Africa's headline inflation is forecast to fall from 6.3 percent in 2009 to 5.8 percent this year, in which case it will move towards the inflation target range of 3–6 percent.

In Botswana, expectations are that the exchange rate influence on import prices will be minimal. The Bank's inflation objective range of 3–6 percent is very close to the forecast trading partner countries' inflation range of 3–5 percent. This means that the downward crawl of the nominal effective exchange rate that is required for maintaining a competitive real effective exchange rate should be small in 2010. Overall, the effect of imported inflation on domestic inflation transmitted through foreign price increases is also expected to be minimal.

Although the domestic economy is expected to grow in 2010, total output is projected to remain below trend in the medium-term, due to the lingering effects of the global recession and the planned cuts in government expenditure. In addition, growth in household disposable income and, consequently, demand for domestic goods and services, is likely to be sluggish due to the continuing wage freeze for civil servants, the planned increase in value added tax, other government levies and utility tariffs. Moreover, the improvement in business confidence that may have taken place so far due to the increase in government spending, could be dampened by the planned expenditure cuts.

So far, on the basis of available information, inflation will rise modestly in the short-term, largely as a result of the increase in value added tax, but it will subsequently stabilise around the Bank's medium-term objective range of 3–6 percent next year.

Therefore, Honourable Ministers, Distinguished Ladies & Gentlemen, the outlook for inflation and output suggests a largely neutral monetary policy stance in the medium term. With prospects for low and stable inflation, and in an environment in which the Government's contribution to economic activity is constrained by limited revenue, it is of paramount importance that coordinated and complementary monetary and fiscal policies remain the order of the day, in the best interest of sustainable economic growth. It should be pointed out that the projected short-term increase in inflation implies a need to keep inflationary expectations in check. Needless to add, uncertainties cannot be ruled out. Accordingly, therefore, as events unfold during the course of the year, the Bank will respond appropriately and timely to attain price stability and to ensure that inflation remains within the medium-term objective range of 3–6 percent, without undermining sustainable economic growth.

Distinguished Guests, Ladies & Gentlemen:

This concludes my Statement, and I thank you for your attention. Please enjoy the rest of the evening.