Linah K Mohohlo: Botswana's Monetary Policy Statement for 2012

Remarks by Ms Linah K Mohohlo, Governor of the Bank of Botswana, at the launch of the Monetary Policy Statement for 2012, Gaborone, 20 February 2012.

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I welcome you to the launch of the Monetary Policy Statement for 2012, which is the 15th in a series since the inaugural launch in 1998. The Monetary Policy Statement and its mid-term review are of central importance to the Bank, as they are a vehicle for conveying to stakeholders all pertinent information relating to the formulation and implementation of monetary policy.

Those familiar with the contents of past years' Statements will recall that they contain analysis of recent and prospective economic developments, here at home and abroad, which enable stakeholders to objectively assess the Bank's policy stance and how such policy is derived from the framework. It also explains the manner in which monetary policy is conducted. This information helps to foster policy credibility; it also helps to anchor public expectations of the Bank's commitment to maintaining a low, predictable and sustainable level of inflation. Stakeholders then use the information on inflation expectations and other factors in their saving and investment decisions, the choices which are indispensable for sustainable economic growth. Since saving and investment decisions require medium- to long-term perspectives on a broad range of economic factors that include inflation expectations, and the effect of anti-inflation monetary policy also takes a while, the inflation objectives are expected to be achieved over the medium–term horizon.

For this morning's business, Distinguished Ladies and Gentlemen, I will highlight the key elements of the Monetary Policy Statement for 2012. These are: the monetary policy framework and objectives; inflation trends; and the conduct of monetary policy in 2011. I will also outline the inflation outlook and the monetary policy stance for this year. The details are in the bound copies of the Monetary Policy Statement, which you will receive at the end of the proceedings.

As a prelude to outlining the main contents of the Monetary Policy Statement, I believe it is essential to put it in perspective by briefly restating the key functions of the Bank. Although they are subject to periodic review, the statutory objectives remain unchanged. They include ensuring that commercial and other banks, which are under the regulatory and supervisory purview of the Bank, are sound and well managed. After all, they serve as conduits for payments and transmission of monetary policy. It is also the Bank's business to ensure that the payments system, a part of which is the effective management of the national currency, is efficient and secure. Capacity in this area is continuously enhanced to respond to broader issues of financial stability, which have become important in the current environment of heightened uncertainty over the health of the global financial system. The Bank also provides both banking services and the lender of last resort facility to commercial banks. Similarly, the Bank is banker to the Government, which it also serves as economic and financial advisor.

Furthermore, much of the country's financial assets is managed by the Bank in the form of foreign exchange reserves. The reserves are invested in international financial and capital markets which, as we speak, are in turmoil due, largely, to the sovereign debt crisis in the Euro area. This turbulence is compounded by the consequent downgrading of sovereign credit ratings of a number of industrial countries which, hitherto, enjoyed high investment grade ratings. Despite these developments, I wish to reassure you and other stakeholders that the management of reserves will continue to be guided by the Bank's well established investment policies and guidelines, as periodically reviewed. In this respect, the level of reserves as of the end of January 2012 was approximately 60 billion Pula (or 8 billion USD), which is equivalent to 18 months of imports, an improvement over last year's 15 months import cover.

Speaking of sovereign credit ratings, Botswana's ratings, as awarded by the two main international sovereign credit rating agencies, Moody's Investors Service and Standard & Poor's, continue to be of the investment grade "A", and compare favourably with those of other countries in its league. I hasten to add that, despite this good standing, Botswana's credit ratings remain vulnerable to the vagaries of international financial and capital markets and other global economic factors over which the country has little or no control. On our part, however, it is very important to return to the erstwhile fiscal rectitude and sustainability, enhance productivity and expand the economic base, in order to withstand external shocks.

Honoured Guests:

I now turn to the subject of Monetary Policy, and wish to suggest that the importance of effectively formulating and implementing monetary policy is well known and self-evident. It goes without saying that a low, predictable and sustainable level of inflation contributes to the attainment of the broader national objective of a stable and sustained economic growth. Price stability also fosters international competitiveness of domestic producers by stabilising the trade-weighted exchange rate (also known as the real effective exchange rate), in conjunction with the crawling of the nominal trade-weighted exchange rate (also referred to as the nominal effective exchange rate). It is gratifying, therefore, that the Bank's biannual Business Expectations Surveys continue to indicate broad-based support for the inflation objective and the exchange rate regime.

In pursuit of price stability, the Bank uses interest rates and open market operations to influence demand and supply conditions in the economy and, ultimately, the rate of price increases. The timing and size of any interest rate change is derived from the monetary policy framework, which incorporates an assessment of prospective domestic and external economic developments that influence price movements. On the basis of the framework, the Bank forecasts inflation in the medium-term; it is this inflation forecast which, in turn, informs the monetary policy response. In this case, monetary policy is adjusted to address a sustained deviation of the medium-term inflation forecast from the medium-term inflation objective range. Even so, a change is undertaken when it is considered that the underlying inflationary factors can be influenced by monetary policy.

It is the Monetary Policy Committee of the Bank which considers these factors and decides on the direction of monetary policy. As you will have observed, the outcome of the Committee's deliberations is disseminated through the media to stakeholders, in order to help anchor inflation expectations and buttress policy credibility, which is critical in achieving long-term price stability.

Let me now highlight the economic and financial developments of 2011, as background for the policy posture of the period. From a global standpoint, there was upward pressure on inflation in the first half of 2011, particularly in emerging market economies, due to an increase in commodity prices, especially for oil and food products. The increase in the price of oil was worsened by political and social conflict in the Middle East and North Africa. However, inflation slowed down as the year came to an end, due to a slack in global demand and economic activity.

The trade-weighted average inflation for Botswana's trading partner countries increased, from 2.8 percent in 2010 to 4.8 percent at the end of 2011. The SDR countries, which are the United Kingdom, United States of America, Japan and Euro area, experienced a significant increase in prices; the average inflation rose from 1.8 percent in 2010 to 2.9 percent in December 2011. In South Africa, headline inflation increased markedly, from 3.5 percent in December 2010 to 6.1 percent by the end of 2011, slightly breaching the upper end of the medium-term target range of 3 – 6 percent. This was attributable, in large part, to an increase in the price of food.

As anticipated in last year's Monetary Policy Statement, domestic inflation was above the medium-term objective range of 3 – 6 percent throughout 2011, due mainly to higher food prices. Other causes of rampant inflation included the increase in administered prices for fuel, public transport and electricity. Inflation then rose from 7.4 percent in December 2010 to 8.5 percent in the first quarter of 2011, as a result of the increase in private school fees and petrol prices. After easing slightly to 7.9 percent in June 2011 following the reduction of telephone tariffs, inflation resumed its upward trend and reached 9.2 percent at the end of last year, in response to the upward adjustment of fuel prices and transport fares, as well as the increase in the cost of food, health services and household durables. All measures of inflation went up last year. When administered prices are excluded, inflation rose, although at a slower rate, from 7.1 percent in December 2010 to 7.5 percent by year-end; similarly, the trimmed (16 percent) mean measure of core inflation increased from 7.7 percent to 8.5 percent.

The effect of demand on inflation was limited since economic activity remained below long-term levels. Furthermore, the modest public service salary increase of September 2011 meant that household demand remained constrained. In addition, government expenditure growth was similarly tight with a view to balancing the budget by fiscal year 2012/13, the objective of which has been more than attained in view of the budgeted small surplus. Nevertheless, faster credit expansion helped to stabilise aggregate demand. For instance, bank lending to businesses increased by 41 percent last year, compared to only 11.3 percent the previous year; and credit to households rose by 15.8 percent in 2011, which is higher than the 12.5 percent growth rate of the previous year. Overall, the annual growth in private sector credit more than doubled in 2011, from 11.9 percent to 26.4 percent.

Besides the domestic and external inflation environment of 2011, monetary policy was conducted against the background of global economic instability and uncertainty, to which I referred earlier. Oil prices were volatile, the Euro area sovereign debt crisis worsened and this created turmoil in major financial markets, which brought about fears of renewed banking crisis. Most industrial economies experienced persistent high levels of unemployment which, together with fiscal restraint, constrained demand. Moreover, supply disruptions caused by the earthquake and tsunami in Japan in March 2011 also adversely affected global production. Overall, and despite higher output growth rates in emerging economies, global growth was dampened and the trend was economic slowdown in the second half of the year.

Although global inflation went up in 2011, it did not present a medium-term threat to the need for monetary policy to address the slowing economic activity; neither did it present a threat to the need to address persistent high unemployment and idle capacity in major economies. As a result, most developed countries' central banks, including the United States Federal Reserve Bank and the Bank of England, maintained low policy interest rates throughout 2011. This was complemented by other measures such as adding liquidity to the banking system, which is referred to as quantitative easing. Towards the end of the year, the European Central Bank reversed the earlier increase in interest rates and also introduced quantitative easing, in an effort to stabilise financial markets. Similarly, some emerging market economies (notably those of Brazil and China) that had earlier increased interest rates also loosened monetary policy by year-end. India was the exception in this respect, as monetary policy was tightened.

Here at home, the conduct of monetary policy was guided by a positive medium-term inflation outlook that reflected a low level of domestic demand and benign external influence on inflation. In the circumstances, the Bank Rate was maintained at 9.5 percent in 2011. The commercial banks' prime lending rate was also unchanged at 11 percent.

However, the Bank implemented two measures. First, the primary reserve requirement for commercial banks was increased from 6.5 percent to 10 percent with effect from July 2011, in order to reduce the amount of liquidity that is absorbed by Bank of Botswana Certificates.

Second, four months later in November 2011, the maximum issuance of Bank of Botswana Certificates to absorb excess liquidity was limited to P10 billion. The reduction of Bank of Botswana Certificates issuance is intended to encourage banks to actively seek and finance bankable projects that would contribute towards economic diversification; it would undoubtedly also contribute to their bottom lines.

Distinguished Guests:

It follows that the outlook for domestic inflation is predicated on expectations of slower global output growth. Indeed as the impact of the Euro area sovereign debt crisis worsened, the forecast for global output for 2012 was reduced from 3.8 percent to 3.3 percent. Furthermore, despite recent encouraging indicators, the pace of economic recovery in the US continues to be constrained by failure to agree on the necessary fiscal policy measures.

In contrast, economic activity in emerging market economies is expected to remain buoyant, particularly in China and India, although these countries' economies are also vulnerable to any major global economic slowdown. The forecast overall slow global economic expansion clouds prospects for trade; it also reduces the threat of inflation in emerging market economies, and dampens the impact of an increase in commodity and food prices. Therefore, although there are underlying inflation pressures in emerging market countries due to relatively buoyant economic activity, overall global inflation is projected to decline from 4.6 percent in 2011 to 3.4 percent in 2012. As a result, monetary policy is expected to be generally accommodative in these countries.

With respect to SDR countries, inflation is forecast to decline from 2.9 percent in 2011 to 1.8 percent this year. In South Africa, headline inflation is projected to increase only slightly, from about 5 percent in 2011 to 5.8 percent.

All in all, it is expected that the effect of external price developments on domestic inflation will be negligible.

Given that the Bank's medium-term inflation objective range is still 3 – 6 percent, and the forecast average inflation range for trading partner countries is 3 – 5 percent, it follows that the nominal effective exchange rate will crawl down only minimally in 2012, in order to stabilise the real effective exchange rate. This will continue to support international competitiveness of domestic industries, as a contribution to economic diversification.

Moderate output expansion is projected for the domestic economy, with non–mining output remaining below potential. Mining production is expected to be maintained at current levels, although this is subject to sustained global demand. There are expectations that, in the course of the year, some new mining ventures could commence operations and, if that were to be the case, there would be a boost to total mining output. However, non-mining sector performance could be weighed down by the limited domestic fiscal stimulus, as nominal government expenditure is only budgeted to increase marginally (0.1 percent) in 2012/13 and nominal personal incomes will continue to be sluggish. This outlook was also reflected in the fall in business confidence indicated in the recent (September 2011) Business Expectations Survey.

Although pressures on inflation arising from domestic demand are expected to be limited and the impact of foreign price developments are likely to be minimal this year, prices could go up due to an increase in the international cost of food that would exceed current projections. Inflation may also rise in the event of any substantial upward adjustment in administered prices and government levies. In this respect, I wish to state the obvious, and that is, while the reasons for increasing utility tariffs are understandable, large adjustments increase inflation which, in turn, erodes living standards and well-being of households. It is for this reason that service providers are encouraged to make every effort to contain costs by enhancing efficiency, in order to minimise the adverse impact on consumers.

Distinguished Ladies and Gentlemen:

So far as the monetary policy stance for 2012 is concerned, domestic inflation is forecast to remain above the medium-term objective range in the short-term, as the impact of the recent cost increase tapers off gradually. However, it is anticipated that inflation will converge to the medium-term objective range of 3 – 6 percent in the second half of 2012, due to the dampening effect of underlying domestic and international economic prospects. Therefore, the prospects for a low, predictable and sustainable inflation in the medium-term will give rise to the conditions that would permit a counter-cyclical accommodative monetary policy, which would cushion the contractionary impact of restrained fiscal policy on economic activity.

It should be stressed, however, that, in order to avoid an entrenchment of persistently high inflation, the Bank's monetary policy stance will continue to be guided by the extent to which short-term price developments generate medium-term inflation expectations. More generally, and as expected, the Bank will respond in a timely manner to any sustained deviation of the medium-term inflation forecast from the medium-term inflation objective range of 3 – 6 percent, without undermining the much needed sustainable economic growth.

Honourable Minister of Finance and Development Planning and your Cabinet Colleagues, Honourable Members of Parliament, Your Excellencies Members of the Diplomatic Corps, Distinguished Ladies and Gentlemen, this concludes my submission of the Monetary Policy Statement for 2012.

I thank you most sincerely for your attention.