BANK OF BOTSWANA

2017 MONETARY POLICY STATEMENT

by

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Governor

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Introduction

It is indeed a great pleasure and honour to welcome all of you, on behalf of the Board, management and staff of the Bank, to the launch of the 2017 *Monetary Policy Statement*. This is an important and priority occasion in the annual calendar of events for the Bank. We are therefore most grateful to all of you, Distinguished Guests, for gracing the occasion with your presence this morning.

The launch and dissemination of the Monetary Policy Statement is consistent with the key governance imperatives of transparency and accountability in the formulation and implementation of monetary policy. The Statement seeks to promote an understanding of the conduct of monetary policy and its objectives and, accordingly, guide the public's formation of expectations. It is on this occasion, that the Bank reports on inflation trajectory and policy performance as articulated in the previous year's Statement; outline and convey the Bank's perspective on economic and other policy developments; and, in turn, how the Bank intends to respond and implement monetary policy.

Esteemed Guests, I would like to start with recognition of the immense contribution of the past leadership of the Bank in the design and shaping of the current monetary policy framework, and in particular, my predecessor, former Governor, Ms Linah Mohohlo. She presided over important innovations that helped engender policy credibility and performance in meeting the inflation objective as well as fostering effectiveness and stability of the banking system. As you would be aware, inflation in Botswana has been, since June 2013, either within or below the desired objective range. This is the single most important contribution to demand management and macroeconomic stability that you can ask of your Central Bank.

Indeed, the Bank's primary statutory mandate is to maintain price stability. Along with this mandate, the Bank is responsible for promotion of a safe and sound financial system as well as efficient payments infrastructure. Price stability, which is defined as low, stable and predictable level of inflation, fosters mobilisation of savings, productive investment, prudent allocation of credit and international competitiveness of domestic firms. In turn, a sound and stable financial system is potentially more effective in policy transmission and facilitating economic activity through the provision of liquidity and risk mitigation. Therefore, Honourable Minister, let me reaffirm that the Bank's mandate is aligned to, and supports, the national objective of sustainable economic growth.

Improvement to the Monetary Policy Framework

Distinguished Guests, I will now mention some of the important elements of the evolution of the monetary policy framework, over the past two decades. First, is the clarity and definition of the inflation objective and identification of the medium-term performance horizon. Second, development of supporting infrastructure and internal capacity to operate the forecasting and policy analysis system that guides monetary policy decisions. Third, the Bank formalised the institutional arrangements, in the form of a Monetary Policy Committee whose regular meetings are followed by a Press Release, as well as publication of the Annual Monetary Policy Statement and Mid-Term Review. In addition, changes in the exchange rate policy framework also helped enhance the effectiveness of monetary policy. In particular, the adoption of the crawling band exchange rate framework since 2005 and, later, public disclosure of the weights of the constituent currencies in the Pula basket as well as the rate of crawl, has supported the Bank's focus on the inflation objective. This transparency in the management of the exchange rate helps to anchor policy credibility and predictability and, therefore, informs expectations and economic decisions.

As the Bank continues to focus on refining and making improvements, it has been the intention to enhance transparency and interaction with the market, as circumstances would be propitious, with a view to further buttressing policy transmission and credibility. In this regard, the Bank will, henceforth, preannounce the dates for the Monetary Policy Committee (MPC) meetings for the ensuing half year; and, convene a Media Briefing following each meeting of the MPC to announce the policy decision. I hasten to add, Distinguished Guests, that these initiatives are premised on availability, and should be a catalyst for development, of an appropriate market infrastructure and expertise, such as informed and robust market analysis and strong financial journalism, as well as organised debt and credit markets.

Honourable Minister, Ladies and Gentlemen, my message today also addresses three other areas. First, I will briefly examine global trends that have influenced inflation in Botswana; second, I will highlight the conduct of monetary policy, both internationally and here at home; and, finally, I will provide the medium-term inflation outlook and, consequently, the likely policy stance.

External Economic Developments

Looking back, it is estimated that global output growth was 3.1 percent in 2016, compared to 3.2 percent in 2015, and weaker than the projection of 3.4 percent early in the year. The lower growth rate resulted from subdued economic activity in both advanced and emerging market economies, while low commodity prices continued to weigh down on economic performance in commodity exporting countries. International oil prices, however, recovered during 2016, partly in response to the agreement by major producers to reduce production; therefore, potentially generating upward pressure on inflation. Following a generalised decrease in the previous two years, global food prices also increased in 2016.

Due to these factors, global inflation increased slightly from 2.8 percent in 2015 to 2.9 percent in 2016, but much lower than the forecast of 3.4 percent at the beginning of the year. As regards Botswana's trading partner countries, inflation remained low in the Special Drawing Rights (SDR) countries (comprising the United States of America, euro zone, China, Japan and the United Kingdom). Average inflation for these countries increased from 0.7 percent to 1.7 percent in the same period. In contrast, inflation in South Africa breached the upper end of the target range, peaking at 6.8 percent, mainly because of weakness of the South African rand and food price pressures. Overall, average inflation for the trading partner countries increased from 2.8 percent to 4.2 percent during 2016.

Domestic Inflation

In Botswana, inflation was low and stable, and fluctuated around the lower end of the desired objective range of 3 percent, hence broadly consistent with projections for the year. Inflation reached a record low of 2.6 percent in August 2016. The low rate of annual price increase was generalised across most categories of goods and services. However, food price inflation increased from 0.7 percent in 2015 to 3.9 percent in 2016. Also, the reduction of 3.3 percent in fuel prices in 2016 was small compared to a 15.7 percent decrease in the prior year.

In addition to benign external price developments, modest inflation in Botswana was also indicative of subdued domestic demand, against the background of sluggish economic activity and restrained growth in personal incomes. Among the influences on domestic demand are growth in government expenditure, wages and credit. Taking these three elements in turn, government expenditure increased by 9.7 percent in 2016, virtually the same rate of expansion as in the previous year. It should be recognised, in this respect, that the short-term impact of government spending on domestic demand is moderated to the extent that a significant component involves infrastructure and capacity development. In the context of Botswana, this type of spending tends to be import intensive and, also, the economic benefits of such public investments are derived in the medium to long term.

Turning to wage developments, it is notable that government recurrent expenditure included a 3 percent salary increase for the public service, which, as a matter of practice, guided parastatal and private sector wage adjustments. Thus, in 2016, wages increased, generally, by 5.2 percent, therefore, with a modest impact on demand and inflation.

On credit developments, growth in commercial bank credit fell from 7.1 percent in 2015 to 6.2 percent in 2016 in the context of subdued economic activity and restrained growth in personal incomes, which influenced both the demand and supply side. The Bank also recognises challenges in the transmission of the prevailing policy rates to lower lending interest rates. The challenges relate partly to structural issues, such as uncertainty about sustainability of funding sources and associated balance sheet restructuring as well as tighter lending criteria by banks. Against this background, the annual expansion in lending to households fell from 12.8 percent to 7.6 percent and included lower growth for personal loans and mortgages.

In contrast, growth in business credit increased to 4.2 percent, from a contraction of 0.3 percent in 2015, but with varying performance across sectors. Overall, the moderate increase in bank lending supports economic activity and it is broadly consistent with growth of nominal GDP.

Monetary Policy Implementation in 2016

Honourable Minister and Esteemed Guests: Monetary policy was predominantly accommodative in advanced economies, with low levels of interest rates; in some instances, interest rates are negative, while liquidity support to the financial sector was maintained. In this regard, notable developments include the reduction of interest rates in the United Kingdom aimed at mitigating the adverse impact of the decision to leave the European Union (Brexit) and the second increase in interest rates in the United States of America since 2008, given progress in attaining full employment and price stability.

For emerging market economies, the direction of policy changes was mixed, invariably reflecting differing macroeconomic circumstances. Closer to home, the South African Reserve Bank increased the policy rate by 75 basis points to 7 percent during 2016 in order to anchor inflation expectations around the country's target range of 3 – 6 percent.

Domestic Monetary Policy Implementation

For its part, the Bank continues to conduct monetary policy through a forecast-based policy framework that informs the appropriate response to deviations of inflation from the desired objective range. The analysis also involves assessment of divergence of actual output (GDP) from potential output (technically known as the "output gap"), which is the primary indicator of the direction of future inflation. The forecast incorporates projections of foreign inflation, exchange rate movements and changes in domestic administered prices and taxes. In addition, the Bank undertakes a careful evaluation of risks associated with the projected outlook. In determining the appropriate policy response, the inflation forecast is considered alongside indicators of financial stability and economic activity, including relevant information from the Business Expectations Survey conducted biannually by the Bank.

Monetary policy during 2016 was conducted in an environment of below-trend economic activity and a positive medium-term inflation outlook, providing scope for policy easing. Indeed, the Bank Rate was reduced further by half a percentage point to 5.5 percent in August. Accordingly, commercial banks also reduced the prime lending rate by half a percentage point to 7 percent.

Nevertheless, there was a build-up of excess liquidity in the banking system as commercial bank credit expansion slowed relative to the increase in deposits. Monetary policy was implemented with a view to encourage productive commercial bank lending and market efficiency, as well as ensuring cost-effective absorption of excess liquidity in the banking system, through a limited issuance of Bank of Botswana Certificates (BoBCs). This was balanced with the need to keep money market interest rates aligned with the monetary policy stance, a consideration that allowed for some flexibility in the issuance of BoBCs.

Honoured Guests, as in the previous years, monetary policy was also implemented in a way that safeguards the stability of the financial system. Notably, the slower household credit growth was in line with modest increase in personal incomes, while the restrained expansion in mortgage lending was also consistent with a weaker residential property market. In this respect, the ratio of non-performing loans to total credit was modest at just under 5 percent. Overall, the banking system satisfied, and in most cases, significantly exceeded the minimum prudential requirements, which is indicative of a generally healthy, sound and stable financial system.

Economic Outlook and Projections

Now looking ahead, the global economy is expected to grow by 3.4 percent in 2017. The projected improvement is premised on anticipated stronger emerging market economies, including a recovery from recession in Brazil and Russia. In advanced economies, growth is expected to be supported by relatively low oil prices, improving labour markets and possible fiscal stimulus in the United States of America. Nonetheless, global economic performance is subject to uncertainty of the policy environment associated with the potential for inward-looking and protectionist trade policies as well as geopolitical tensions. Other downside risks emanate from persistence of tight financing conditions in some key markets and subdued commodity prices.

Global inflation is forecast to be 3.3 percent in 2017 as advanced economies reflate to achieve the desired targets and as the effect of the earlier decrease in energy prices dissipates. In emerging market economies, inflation is expected to moderate as the effect of previous currency depreciation tapers off in 2017. In this environment, it is anticipated that monetary policy will remain accommodative in most economies, complemented by measures aimed at facilitating effective financial intermediation and fostering resilience of the financial sector to support economic activity.

Domestic Economy

As the Honourable Minister indicated in the 2017/18 Budget Speech, the domestic economy is forecast to grow by 4.2 percent, an improvement from the estimated 2.9 percent for 2016. Furthermore, the budgeted 6.5 percent expansion in government spending, in 2017/18, should continue to be supportive of domestic demand. Government spending comprises elements that generate both short-term growth supporting demand and expansion of productive capacity which, potentially, should sustain future growth prospects.

The exchange rate policy will continue to complement the monetary policy framework and it augurs well for maintenance of international competitiveness of domestic industries and macroeconomic stability. As announced at the beginning of the year and consistent with Botswana's trade pattern, the weights of the constituent currencies in the Pula basket were adjusted from 50 percent each to 45 percent for the South African rand and 55 percent for the SDR. Also, effective January 1 this year, the Bank is implementing a modest upward rate of crawl of 0.26 percent for the nominal effective exchange rate, lower than the 0.38 percent in 2016. The upward crawl reflects the achievement in maintaining domestic inflation at a rate lower than the average for the trading partner countries.

Overall, both external and domestic pressures on inflation are expected to be benign, and it is projected that inflation will remain within the 3 – 6 percent objective range in the medium-term, although, in the near-term, it is expected to rise modestly. This forecast takes into account possible increase in some administered prices, the impact of which, however, is not expected to result in short-term inflation over-shooting the upper boundary of the objective range of 3 – 6 percent. Having said so, it is worth underscoring the point that any upward adjustment in these prices that is substantially beyond current projections presents upside risks to the inflation outlook. In contrast, downside risks to inflation arise from the expected restrained growth in global economic activity and the tendency of technological progress to result in lower prices as well as a possible decline in commodity prices.

Conclusion and Monetary Policy Stance

Distinguished Guests, as I conclude my remarks**,** I would like to restate that current projections, based on available data, suggest that inflation in Botswana will, in the medium-term, remain within the Bank's objective range of 3 – 6 percent. This positive medium-term outlook for inflation is in the context of anticipated higher GDP growth in 2017 and a sound and stable financial system. Therefore, prospective developments augur well for maintenance of an accommodative monetary policy that supports productive lending to businesses and households. The Bank's implementation of monetary policy will continue to focus on entrenching expectations of low, predictable and sustainable inflation, through timely responses to price developments; while, at the same time, taking due care to ensure that policy decisions are consistent with enduring financial stability and supportive of sustainable economic growth.

Honourable Minister and Distinguished Guests, it is important to note that the continuing success in containing inflation within the desired 3 – 6 percent medium-term inflation objective, to which the Bank remains fully committed, must, in the end, involve the cooperation of all key players in the economy, namely, Government, parastatals and the private sector, for the good of the country as a whole.

Let me also take this opportunity to remind the Media about the scheduled Press Briefing, to be held tomorrow morning at 1130 in the Bank, after the first MPC meeting of the year. The Briefing will cover both this Monetary Policy Statement and announcement of the Monetary Policy Committee decision.

Honourable Minister, Distinguished Guests; I thank you for your kind attention.