Linah K Mohohlo: 2003 Monetary Policy Statement

Statement by Mrs Linah K Mohohlo, Governor of the Bank of Botswana, Gaborone, 25 February 2003.

* * *

Introduction

I am privileged and honoured to welcome you to this important event in the calendar of the Bank - the presentation of the Monetary Policy Statement for 2003.

Let me begin by refreshing memories on the objective and content of the Monetary Policy Statement, which the Bank of Botswana issues every year. The Statement serves several purposes. First, it provides an opportunity for the Bank to report on inflation and monetary policy developments in the previous year, and to present its assessment of the outlook for inflation in the current year. Second, it enables the Bank to outline policy issues and the approach that will be taken in formulating its policy stance in response to inflation-related developments throughout the year. Third, the Monetary Policy Statement contains, certainly since last year, the Bank's annual objectives for inflation and credit growth, and an explanation of how these are derived. The Statement, therefore, plays an important role in conveying to stakeholders and the public at large a range of information relating to one of the Bank's core functions - the formulation and implementation of monetary policy.

While the transparency entailed in the presentation of the Monetary Policy Statement is important in its own right, it is also important in influencing economic and financial expectations, as well as the behaviour of economic agents. The Bank's aim is to engender a public expectation of sustainable low inflation consistent with the broad objective of macroeconomic balance as a basis for sustainable growth. In addition, the Statement serves as a vehicle for enhancing the accountability of the Bank to its stakeholders.

In my remarks this evening, I will present only the main highlights of the full text of the 2003 Monetary Policy Statement. It is important, therefore, that you take the time to read the full text of the Statement, so you can obtain a more detailed analysis of monetary policy developments.

I will briefly review the behaviour of inflation in 2002 and its underlying causes, before assessing the extent to which monetary policy succeeded in achieving its objectives in 2002. I will then outline the Bank's view of prospective economic and financial developments in 2003 and, on the basis of that assessment, the policy outlook for the current year.

The Bank's Monetary Policy Framework and Objectives

I believe you are aware that the principal objective of monetary policy in Botswana, as it is for most central banks around the world, is to control inflation; in particular, it is to ensure that inflation is predictable and maintained at low levels. By carrying out this responsibility of controlling inflation, the Bank contributes, along with other Government policies, to the ultimate objective of promoting a stable macroeconomic environment. This supports rising incomes and living standards for Batswana, along with other national objectives, especially economic diversification which, in turn, depends on export competitiveness. You will agree that export competitiveness cannot be achieved unless Botswana's inflation is low and comparable to the average of trading partner countries, such as South Africa, the United Kingdom, the United States of America and mainland Europe. This requirement is the basis for determining the desired range of inflation.

The framework within which policy is determined identifies the key relationships of the inflationary process. It is a well-known fact that excessive expenditure in relation to available goods and services in any given period pushes up prices - this is the concept referred to as demand-pull inflation. It is also well known that much expenditure, especially by the private sector, is financed through borrowing from the banking system. Hence the Bank determines the growth rate in bank credit that would be consistent with a low and sustainable level of inflation. The framework also identifies the tool used in controlling inflation, and as is the case with most central banks, the tool used by the Bank is interest rates. Obviously in deploying the interest rate instrument, the Bank strikes a careful balance between the need to discourage excess credit growth, and the need to encourage productive investment as well as financial savings.

In formulating the monetary policy stance, the Bank closely examines the factors that influence inflation. This analysis is necessary because the Bank is only equipped to deal with changes in inflation which are primarily due to domestic demand pressures. Furthermore, such pressures tend to have persistent, rather than erratic effects, such as those that may be due to transitory developments or supply fluctuations. That is why, in addition to the headline inflation data published by the Central Statistics Office, the Bank examines the underlying inflation trend, or core inflation. This is a measure of inflation which excludes the impact of factors which are transient in nature; it also excludes exceptional changes in administered prices and/or indirect taxes, and is a more precise measure of price developments in any economy. The Bank recognises the need, however, to respond to any impact that the transitory developments may have on underlying inflation, particularly their effect on inflation expectations and second-round influences on price changes.

In a market-based economy such as Botswana's, monetary policy influences inflation indirectly through its effect on interest rate changes, which then influence credit as a key means of financing expenditure on both consumption and investment. The effectiveness of interest rates in controlling credit is monitored closely. The Bank also recognises that the rate of growth of government spending is an important component of domestic demand, since the Government allocates large amounts of funds to finance public consumption and investment. The fact that the Government plays a large role in the economy underscores the need for complementarity between fiscal and monetary policies in achieving the inflation objective.

This is the policy framework that provides a backdrop to the Bank's assessment of the economic and financial environment over the past year, in which inflation or price developments took place.

Developments in Inflation in 2002

As you will no doubt recall, the Monetary Policy Statement for 2002 set an inflation objective range of 4 - 6 percent. In setting this objective, the Bank was aware that headline inflation would be influenced by a number of transitory factors, especially the introduction of the 10 percent Value Added Tax (VAT) in July 2002. Before the introduction of VAT, annual headline inflation stabilised at around 6 percent during most of the first half of 2002. However, following the introduction of VAT, and as you will recall, inflation started rising, and increased from 5.9 percent in June 2002 to just over 11 percent by the end of the year. The Bank had anticipated a temporary increase in headline inflation arising from the introduction of VAT, of between 4 percent and 6 percent over and above underlying inflation. This prospect was conveyed in a press release in June 2002. It was pointed out, at the time, that the VAT-related price increases would be a one-off temporary adjustment and that, in the absence of any significant second-round price effects, due for instance to compensatory wage increases, the impact of VAT would not result in a sustained rise in inflation.

In the event, and in line with the Bank's expectations, the effect of VAT was that the month-on-month rate of change in prices rose from an average of 0.5 percent over the twelve months to June 2002, to 3.2 percent a month later in July 2002. Thereafter, the monthly rate of price increases progressively slowed down to reach 0.4 percent in October. The monthly price increase was then higher in November, primarily due to technical adjustments to some components of the Consumer Price Index (CPI) basket, particularly the adoption of a new billing system by the Botswana Telecommunications Corporation.

Although overall inflation increased sharply in the second half of the year, an analysis of the inflation trend that discounts the impact of VAT and other technical adjustments to data suggests that underlying inflation was around 6 - 7 percent for 2002, which was a little above the upper end of the Bank's policy objective for that year.

A closer look at the sources of inflation in 2002 provides further support to the conclusion that, while headline inflation was influenced by VAT and other price adjustments, the underlying rate was mostly contained. Prices of almost all categories of commodities rose at a higher rate in 2002 compared to 2001 as had been expected, given the wide-ranging impact of VAT. Food prices, however, rose at a much faster rate than the average, due in part to drought conditions in the region. Food price inflation rose from approximately 4 percent in December 2001 to over 14 percent by the end of 2002. This accounted for almost half of the rise in overall inflation during the year, and reinforces the view that, after taking account of the impact of VAT and other exceptional factors, such as volatile food prices, underlying inflation was largely contained during 2002.

The relatively moderate rise in underlying inflation was to some extent supported by a fairly benign inflationary environment in the world's major economies. Although all major economies experienced moderately higher inflation, mainly as a result of rising energy prices, especially oil, average inflation rose by less than 1 percentage point, from 1.2 percent in 2001 to 2 percent in 2002. The inflation trend in South Africa was somewhat different; price increases were sharp, mostly due to the effects of the depreciation of the rand that had occurred towards the end of 2001. Inflation in South Africa was also affected by increases in food prices and labour costs. Core inflation in South Africa was 12.2 percent in December 2002 compared to 5.8 percent at the end of 2001.

The combined effect of all these developments was that average inflation of Botswana's trading partners rose from 4.2 percent at the end of 2001 to 8.4 percent at the end of 2002, and was reflected in a rise in the cost of imports. In this connection, it should be pointed out that Botswana's inflation briefly fell below that of trading partner countries in the middle of the year, although it was subsequently higher due to the impact of VAT.

In light of the moderate upward trend in underlying inflation, the Bank continued to restrain the growth rate of commercial bank credit to the private sector. After an adjustment to take account of the extension and subsequent early repayment of loans by certain large borrowers, using offshore funds, credit rose by 21.4 percent over the year, compared to 18.1 percent in 2001. This growth rate was well above the Bank's target range of 12.5 - 14.5 percent, which had been judged to be consistent with the economy's underlying growth potential and the inflation objective.

Moreover, the high rate of growth of Government spending, estimated at 18 percent during 2002, albeit below the 20 percent growth rate recorded in 2001, also continued to exert pressure on inflation, thereby placing a heavier burden on monetary policy. The expansionary fiscal policy implied an undesirable imbalance between fiscal and monetary policies in dealing with inflation.

Monetary Policy Implementation During 2002

In light of the high growth rate of credit and the need to contain inflationary expectations following the introduction of VAT, the Bank tightened monetary policy towards the end of the year by raising interest rates by a total of 1 percent in October and November 2002 - half a percent at each time.

Consistent with past practice, the two changes in interest rates were immediately followed by press releases, which emphasised that the increase in interest rates was not a response to the rise in inflation resulting from the introduction of VAT, because the Bank considers the VAT-induced impact on inflation as a transitory event, which did not directly justify a monetary policy response. The Bank's focus was on the impact that VAT may have on inflationary expectations. Hence it was important to forestall the development of expectations of higher inflation by pointing out the dangers of accommodating second-round effects of VAT-related price increases and advising against possible compensatory wage increases. Higher interest rates were, therefore, aimed partly at ensuring that such expectations do not develop. This was done in order to demonstrate the Bank's commitment to containing inflation arising from any temporary VAT-related price increases, and in order that expectations of rising prices do not become entrenched. There was also a need for a tighter monetary policy given that credit growth was still higher than desired.

The effect of the exchange rate on inflation was benign during 2002. While the Pula appreciated in nominal terms against major international currencies, it depreciated by 8 percent against the rand, resulting in an overall stable nominal effective exchange rate of the Pula. However, as inflation was higher in Botswana than in trading partner countries, largely due to the impact of VAT, the real effective exchange rate of the Pula appreciated by 2.6 percent in the year to December 2002; and to that extent, Botswana's trade competitiveness was eroded.

The Outlook for Inflation in 2003

The performance of the global economy is expected to improve further in the course of 2003, with world output currently forecast to grow by 2.5 percent, up from an estimated 1.7 percent for 2002. Despite the forecast improvement in growth, inflation is expected to remain low and stable since the growth in world output will still be below trend. There is, however, considerable uncertainty with respect to oil prices due to the situation in the Middle East and Venezuela, as well as an imminent war in Iraq. Nevertheless, as inflation continues to be largely under control, it is anticipated that major world economies will maintain stimulative monetary policy which, in some instances, will be supported by expansionary fiscal policy.

Inflation in South Africa, which is the most important external influence on inflation in Botswana, rose sharply during 2002. It is, however, expected to slow down in 2003, reflecting the recent strengthening of the rand, the tight monetary policy stance and supportive fiscal policy. Despite these favourable developments, it is unlikely that South Africa's inflation target of 3 - 6 percent will be met during 2003. Forecasts of core inflation in South Africa for the year put it at between 7 percent and 8 percent, from just over 12 percent in 2002. For the other key trading partners, inflation is expected to remain around its current rate of 2 percent. Therefore, if the nominal effective exchange rate of the Pula is unchanged, Botswana's imported inflation is likely to be lower in 2003 than it was last year.

Demand in Botswana, as reflected by the growth in commercial bank credit and government expenditure, was still undesirably high by the end of 2002. However, it is expected that the increase in interest rates in the last quarter of 2002 will, in due course, moderate the growth in bank lending. Furthermore, the recently released 2003/04 Government Budget indicates that expenditure will grow at a much slower rate of around 4 percent. This laudable fiscal restraint, together with the expected reduction in credit growth, should help to moderate inflationary pressures. The Government's decision not to award a public sector pay rise in 2003 should contribute further towards restraining demand pressures. It is hoped that this favourable scenario will not be undermined by the findings of the ongoing Salary Structure Review Commission. Be that as it may, prospects for 2003 are generally of a better balance between monetary and fiscal policies, and this augurs well for a sustainable lower inflation in 2003.

Against this background, it is the Bank's view that inflation in the first half of 2003 will be around the present level of 10 to 12 percent, before falling by the middle of the year and during the remaining months of 2003. This projection is based on the fact that most of the year-on-year effect of VAT on the Consumer Price Index will drop out after July 2003. The outlook is also predicated on the success of monetary policy in restraining credit growth, and the fact that government spending will indeed slow down. It is also expected that there will be no further undue external inflationary pressures generated by further large increases in prices of food and/or oil, or import prices more generally.

Bank's Monetary Policy Stance in 2003

As highlighted earlier, the Bank seeks to achieve a rate of inflation that, at a minimum, will maintain relative stability in the real exchange rate and avoid the need for a devaluation of the Pula. The annual inflation objective is based on an assessment of forecast inflation for trading partner countries. Although the forecast for Botswana's trading partners' inflation for 2003 is slightly higher than the initial forecasts for 2002, which were used in the calculations of last year's inflation objective, there are strong reasons for maintaining the inflation objective range of 4 - 6 percent for 2003. First, by reducing Botswana's inflation to below the forecast average of trading partner countries, the range of 4 - 6 percent will provide an opportunity to regain some of the competitiveness lost last year as a result of a relatively higher level of inflation in Botswana. Second, underlying inflation remains close to the upper end of this inflation objective, which means that the 4 - 6 percent range remains both a desirable and feasible objective for 2003. Third, there remain concerns about the risks of further VAT-induced increases in inflationary expectations. Hence it is important for the Bank to promote expectations of a sustainable low inflation.

The range for the growth rate of private credit that is considered to be compatible with achieving this inflation outcome is 12 - 14 percent. As in the past, this range is calculated from the expected annual capacity for growth of the non-mining sector of the economy, as contained in the ninth National Development Plan (NDP 9); it is also based on the desired level of 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 main message of this year's Monetary Policy Statement - that inflation should continue to be restrained during 2003. This effort will be supported by an expected favourable external and domestic developments, although there are uncertainties about the price of oil. In major industrial countries, output growth is expected to improve, while inflation is forecast to remain under control. Except for the threat of a possible oil price increase and the lagged impact of last year's inflation increase in South Africa, there is minimal risk of external pressures on inflation.

Here at home, it is anticipated that credit demand will slow down in response to the increase in interest rates in late 2002; this should ease demand pressures and curtail higher inflationary expectations. Moreover, fiscal restraint, as underscored by the much reduced growth rate of government spending for the ensuing fiscal year, is expected to contribute towards reducing inflationary pressures this year.

In light of these prospects, the task for monetary policy in 2003 will be to ensure that underlying inflation does not increase; the objective is also to reverse the upward trend in overall inflation that was experienced in 2002 to a downward path of the Bank's desired range of 4 - 6 percent by the end of this year. While the Bank will continue to respond appropriately to monetary and inflation developments, the fiscal restraint that characterises the 2003/04 government budget should contribute to a balanced sharing of the burden of containing inflation as between monetary and fiscal policies during 2003.

I thank you for having joined us this evening and for your kind attention.

Thank you Director of Ceremonies.