Linah K Mohohlo: Monetary policy framework and objectives in Botswana

Speech by Ms Linah K Mohohlo, Governor of the Bank of Botswana, at the mid-term review of the 2008 Monetary Policy Statement, Gaborone, 24 July 2008.

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Introduction

This year, the mid-term review of the 2008 Monetary Policy Statement (MPS) has more significance, given the changes to the monetary policy framework announced earlier this year in February. You will agree that it is time that we follow up and provide further information and explanation.

Since the new framework was announced, the worst of the financial market crisis that developed in the last months of 2007 may have passed. But aftershocks continue, and the current consensus is that the worst is over. However, concerns about the health of the world economy have multiplied, as slower growth in many economies has coincided with the unrelenting increase in the price of oil and food.

The scale of these challenges and the policy choices are abundantly clear, albeit onerous in the short term. You are aware that many central banks have already acted decisively against the risks of inflation by tightening monetary policy.

Botswana does not have any major influence on global monetary conditions. Nevertheless, the Bank of Botswana remains responsible for preserving monetary and financial stability in the country, and this requires a clear and measured response that is relevant to Botswana's specific situation.

Monetary policy framework and objectives

The changes made to the monetary policy framework are meant to enhance policy formulation in support of the objective of achieving a sustainable, low and predictable level of inflation. Additional factors are now considered more systematically to assess the future path of inflation, indicators of domestic demand and inflation expectations. This assessment involves both statistical and expert analysis and, in view of improved analytical capacity, the Bank decided to discontinue the use of the rate of growth of commercial bank credit as an intermediate target.

Furthermore, in recognition of the fact that monetary policy is inherently forward-looking, and can realistically be successful in the medium term, the Bank now only specifies a medium-term inflation objective (3-6 percent) and reviews inflation projections regularly.

Inflation in the first half of 2008

In the first half of 2008, inflation continued the trend that commenced last October; it rose from 8.1 percent in December 2007 to 14.5 percent in June 2008, which is far above the Bank's medium-term inflation objective range of 3-6 percent. Both measures of core inflation (16 percent trimmed mean and exclusion method) also registered an upward trend.

Rising inflation, both domestically and elsewhere, is attributable mainly to the international price of oil-based products and food. In Botswana, inflation for the category of the consumer price index that includes petrol rose from 2.9 percent in September 2007 to 56.1 percent last month in June, accounting for about three-quarters of the total increase in headline inflation. Food price inflation has remained more stable but high, while for most other items inflation has remained much lower and generally within the medium-term objective. In June, there was some indication of a more widespread acceleration of prices which could, in turn, indicate the emergence of second-round effects.

Pressures from domestic demand abound, as indicated by growth rates of credit and government expenditure, as well as strong output expansion. The real growth of GDP in 2006/07 is estimated at 6 percent, while more recent estimates indicate that economic growth excluding mining and government accelerated further in the second half of 2007.

Monetary policy implementation in the first half of 2008

For the first four months of 2008, the Bank Rate, which had last been changed in June 2007, was at 14.5 percent. At the time, while a short-term deterioration in the outlook for inflation was anticipated, the medium-term projection indicated a sustained improvement. It was also appreciated that there were upside risks arising from the escalating food, fuel and other administered prices, as well as the impact of a wage-induced increase in demand. Hence the Bank's Monetary Policy Committee concluded that the bias was towards monetary policy tightening going forward.

Subsequently, it was clear from the Bank's analysis that the outlook for inflation had deteriorated, with revised forecasts estimating annual inflation to peak at a higher level than previously indicated. Hence the successive increases of 50 basis points each in May and June brought the Bank Rate to 15.5 percent.

It is widely believed that interest rates have only a limited influence on domestic demand in Botswana, as borrowers appear not to respond to interest rate changes. This is based primarily on the observation that growth in bank lending has remained high, despite high interest rates. This argument is weak in several respects, as it does not acknowledge factors such as income growth and the broadening reach of the banking sector, both of which should be expected to encourage more borrowing. Even if borrowing was unresponsive to interest rate changes, it goes without saying that increased costs of borrowing must be accommodated elsewhere in household budgets. Therefore, there has to be an impact in terms of dampening demand overall.

Inflation outlook in the medium term (2008-2010)

Inflation outlook in the medium term is influenced by domestic economic activity, imported inflation and international economic and financial developments. For instance, in South Africa, there are upside risks to inflation due to the increase in food, oil and electricity prices and the forecast depreciation of the rand against international currencies. Hence inflation in South Africa is projected to remain above the upper end of the South African Reserve Bank's 3-6 percent target to the end of 2009, thus necessitating the maintenance of the current tight monetary policy stance.

The situation in Botswana's other trading partner countries (SDR countries) is also characterised by high inflation and, in some cases, the threat of recession looms large.

Domestically, output growth is expected to remain above the long-term trend, and this means that Botswana is not currently facing the dilemma that policy tightening is unduly restricting economic growth. The balance of risks, which the generally tight monetary conditions aim to moderate, is towards domestic demand adding to inflationary pressures. To the extent that the current monetary policy stance is maintained, inflation is expected to reach the Bank's objective range by the end of 2009, all things being equal.

The rate of crawl of the exchange rate is not expected to result in a substantial nominal exchange rate adjustment during 2008. This should not add significantly to inflationary pressures, especially in an environment of a relatively restrictive monetary policy.

The latest Business Expectations Survey points to a deterioration in inflation expectations, and this underscores the importance of staying the course in fighting inflation.

Monetary policy stance

Against this background, there is a need to maintain the current restrictive monetary policy stance going forward, in order to restrain second-round effects and refocus inflation expectations. Otherwise a vicious circle of mounting pressures could make inflation increasingly hard to control, thus requiring more severe policy measures at a later stage.

I hasten to add that the Bank recognises the need to balance the trade-off between the need to control inflationary pressures and the desire to support output expansion; to this end, the impact of the current policy stance on economic growth will be monitored carefully.

It is important to stress that monetary policy is not by itself sufficient to attain price stability. Complementary fiscal policy and the implementation of structural reforms, such as skills development, that can yield significant productivity gains, are also critical, as they help to enhance the resilience of the economy.

I thank you for your attention.