BANK OF BOTSWANA

2019 MONETARY POLICY STATEMENT

by

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Introduction

Distinguished Guests, I am honoured to welcome you, on behalf of the Board, Management and Staff of the Bank, to the launch of the 2019 *Monetary Policy Statement*. This is an important occasion in the Bank's annual calendar of events. We are therefore most grateful to you, Honourable Ministers and our Distinguished Guests, for having made the time to attend today's event.

The launch and dissemination of the *Monetary Policy Statement* are key elements of good governance, transparency and accountability in the formulation and implementation of monetary policy. This is intended to promote an understanding of the conduct of monetary policy and its objectives and, accordingly, guide the public's inflation expectations towards convergence with the Bank's inflation objective; enhancing the prospects for sustainable maintenance of low, stable and predictable inflation. Specifically, the Bank uses the Monetary

Policy Statement to report on the inflation trajectory and policy performance in the past year; to outline and convey its prognosis of economic and other policy developments going forward; and, in turn, the prospective monetary policy response and implementation in the ensuing year.

Distinguished Ladies and Gentlemen, the Bank's monetary policy objective is to achieve price stability, defined as low, stable and predictable level of inflation that is within 3 – 6 percent. Monetary policy formulation is also aligned to safeguarding the stability of the financial system. In this regard, price stability and conducive monetary and financial conditions foster mobilisation of savings, productive investment, prudent allocation of credit and international competitiveness of domestic firms. In turn, a sound and stable financial system is critical for effective transmission of monetary policy signals, facilitating the flow of funds and liquidity, as well as risk mitigation in support of economic activity. Overall, therefore, the conduct of monetary policy and attention to financial stability supports the national objectives of employment creation and sustainable economic growth.

Improvements to the Monetary Policy Framework

Distinguished Guests, you will recall that when launching the 2018 Monetary Policy Statement, I shared with you the prospective refinements and improvements to the monetary policy framework due for implementation in 2018. Notable in this regard, was the publication of Monetary Policy Reports to further improve on communication of economic and policy developments. I am pleased to report that, for the first time, the Bank published two Monetary Policy Reports in August and October 2018. Going forward, the Bank will, in addition to this February Monetary Policy Statement, publish three Monetary Policy Reports in April, August and October, within seven days following the respective Monetary Policy Committee meetings. For the June and December Monetary Policy Committee meetings, detailed Press Releases will be issued. This is to provide a continuous comprehensive update on inflationary developments as well as a context to policy decisions. I must, however, emphasise that all the six meetings of the Monetary Policy Committee in a year are important and involve a careful consideration of any of the three likely outcomes and policy signals: that is, either to increase, decrease or maintain the level of the policy interest rate, which is currently the Bank Rate.

I am also pleased to announce that, the Honourable Minister of Finance and Economic Development approved the establishment of the Financial Stability Council (the Council) for Botswana in April 2018. A Memorandum of Understanding between the four constituent members of the Council, namely, the Ministry of

Finance and Economic Development; Bank of Botswana; Non-Bank Financial Institutions Regulatory Authority; and the Financial Intelligence Agency, will be signed tomorrow, after the first Monetary Policy Committee Meeting of the year. The formation of the Council is a significant step towards facilitating collaboration, cooperation and communication amongst the four government agencies for the purpose of implementing macro-prudential policy.

The other important facet relates to national contingency planning for a financial sector crisis, anchored on proactive macro-prudential assessments, stress testing and a deeper understanding of cross-sectoral interactions of firms and financial markets. Given the nature and construct of financial intermediation and, in particular, the structure of balance sheets of banks, things will and often go wrong. For these reasons, the strengthening of financial sector safety nets, encompassing effective crisis management, recovery and resolution plans as well as a proposal for the establishment of a deposit insurance scheme in Botswana, will form part of the agenda of the Financial Stability Council in 2019.

On this breath, the Bank of Botswana is gravely concerned by the incipient personal greed and reported governance failures in some segments of the financial sector, which has the potential to erode fiduciary responsibilities and, consequently, undermine public confidence in financial markets. I can assure you, Honourable Minister, and indeed the international community that, for its part, the Bank will do all that is necessary, in collaboration with all key stakeholders, to preserve the integrity, safety and soundness of the financial system. This will include working tirelessly to support Government actions and programmes, coordinated by the Financial Intelligence Agency, in continuing to build a robust and sustainable Anti-Money Laundering and the Combating of the Financing of Terrorism architecture for this country.

Honourable Minister, Distinguished Ladies and Gentlemen, the Bank evaluates monetary policy implementation framework on a regular basis for effectiveness, and introduces refinements where necessary. In this respect, during this year, the Bank will adopt what is known as "Reserves Averaging" in the determination of Primary Reserves Requirement for banks and also shorten the maturity of the 14-day BoBCs to seven days. Under "reserves averaging", commercial banks do not have to meet the primary reserve requirement daily but, rather, fulfil this statutory requirement on an average basis over the maintenance period, in our case, a calendar month. Reserves averaging, which is used in some jurisdictions, has been shown to improve liquidity management by commercial banks, foster more effective resource allocation through the interbank market and reduce the demand for excess reserves held for precautionary purposes.

The reduction of the maturity period of the primary Open Market Operations tool, namely, the 14-day Bank of Botswana Certificates (BoBCs), to seven days, should enable shorter and simpler forecasting horizon for liquidity management by both the Bank of Botswana and commercial banks, with more accurate outcomes. In turn, it is expected to provide a solid basis for the starting point of the monetary policy transmission mechanism, supporting the extension of the policy signal along the yield curve. These enhancements require input and cooperation from commercial banks and, in that regard, consultations with the banks will commence shortly, with a view to ensure implementation of these measures within a short period of time.

In addition, during the coming months, the Bank will consult the market on further possible changes to monetary operations and the “anchor policy rate”; for example, whether the Bank Rate or the BoBC rate is the more proximate to market considerations for policy transmission purposes. The objective of these refinements is to enhance the potency of the policy rate in the transmission of monetary policy signals as well as its influence on subsequent market reaction and posture. Furthermore, there is need to spur the development and efficacy of the money markets, for the purposes of effective policy transmission, as well as management, access and flow of liquidity among the commercial banks. It is envisaged that these consultations will be completed by the middle of the year.

Distinguished Guests, alongside these measures, designed to ensure better structural alignment of short-term market rates and desirable policy transmission, any notional ceiling on the issuance of BoBCs will be lifted. This approach allows greater scope and flexibility for unconstrained and, therefore, effective liquidity absorption by the central bank in response to market developments. In addition to these anticipated changes to monetary operations, the Business Expectations Survey which, hitherto, was conducted half-yearly, will be undertaken on a quarterly basis. I must heartily thank those businesses that dutifully participate in the Business Expectations Survey and wish to appreciate their invaluable support and input into the analysis of economic developments and policy responses. I encourage those that are sometimes reluctant to participate, to join us in facilitating comprehensive and informed data and policy analysis.

Honourable Minister, Distinguished Ladies and Gentlemen, allow me, at this juncture, to address three other areas, namely, global trends that have influenced inflation in Botswana; highlights of the conduct of monetary policy, both internationally and here at home; and, finally, provide the medium-term inflation outlook and, consequently, offering a view on the likely future policy stance in 2019.

External Economic Developments in 2018

Global GDP is estimated to have increased by 3.7 percent in 2018, compared to 3.8 percent in 2017, with mixed performance across countries and regions. Among the advanced economies, growth strengthened in the USA, influenced by fiscal stimulus and stronger consumer demand. In contrast, performance faltered in the euro area, the UK and Japan. This was affected, in the main, by policy uncertainty, adverse impact of rising protectionist sentiments on global trade and constraints to implementation of structural and policy reforms. For the emerging market economies, output expansion remained strong, although slowing slightly, in the context of waning financial markets sentiment, trade policy uncertainty, weaker external demand and concerns about China's economic outlook.

Global inflation rose from 3.2 percent in 2017 to 3.8 percent in 2018, mainly due to the increase in international oil prices during most of 2018, which, however, was moderated by the decrease in international food prices. In particular, inflation was subdued in the Special Drawing Rights (SDR) countries, easing slightly from 1.8 percent in December 2017 to 1.7 percent in December 2018. Inflation in South Africa also decreased from 4.7 percent in December 2017 to 4.5 percent in December 2018. Overall, average inflation for the trading partner countries fell from 3.1 percent to 3 percent in the same period.

Domestic Economic Developments in 2018

Domestic output is estimated to have expanded by 5.1 percent in the twelve months to September 2018, compared to lower growth of 2.4 percent in the year to September 2017. This expansion was mainly driven by sustained improvement in non-mining GDP growth and the recovery in mining output.

Inflation was low and stable, and fluctuated around the lower end of the objective range of 3 - 6 percent for most of 2018; and the outcome was broadly consistent with projections for the year. The low rate of annual price increase was mostly due to the decrease in food inflation. Food price inflation decreased from 1.1 percent in 2017 to a negative 0.2 percent in 2018. However, fuel prices increased significantly by 16.1 percent during 2018, due to upward adjustments in May, October and November. This compares to a relatively smaller increase of 9.5 percent in 2017. Overall, the increase in administered prices (including fuel prices, public transport fares, as well as electricity tariffs) added 1.86 percentage points to inflation in 2018.

Distinguished Ladies and Gentlemen, the overall modest increase in prices in Botswana was in the context of subdued domestic demand pressures, as a result of the restrained growth in personal incomes and largely stable foreign inflation. Monetary policy was, therefore, conducted against the background of below-trend economic activity and a positive medium-term outlook for inflation and moderate fiscal expansion. Government expenditure grew by 6.6 percent in 2018 compared to a contraction of 6.3 percent in the prior year. It should be recognised, in this respect, that beyond the increase in wages, 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 the economic benefits of such public investments are derived in the medium to long term.

Regarding wage developments, it is notable that government recurrent expenditure included a 3 percent salary increase with effect from April 1, 2018. However, nominal national wages increased by 2.3 percent, on average, which was below the average inflation rate for the period. These developments suggest a modest impact on domestic demand and inflation. On credit developments, growth in commercial bank credit accelerated from 5.6 percent in 2017 to 7.7 percent in 2018 and included a faster increase in lending to businesses, from 3.2 percent in 2017 to 10 percent in 2018. For households, annual credit expansion fell from 7.2 percent in 2017 to 6.2 percent in 2018, in the context of restrained growth in personal incomes. This included a 7 percent increase in personal loans and 4.9 percent for mortgages, compared to respective growth rates of 9.2 percent and 4.8 percent in 2017. Overall, the rate of credit growth continued to be supportive of economic activity, with minimal risk to financial stability.

Global Monetary Policy Implementation in 2018

Honourable Minister and Esteemed Guests, monetary policy implementation in 2018 varied at the global level, in response to diverse economic performance and inflation developments across countries and regions. It was, however, generally amply accommodative, with low levels of interest rates and continued liquidity support to the financial sector in the euro area and Japan. However, policy rates were increased in the United States of America towards normalisation and, in the United Kingdom, in order to get inflation back to target.

Monetary policy implementation was also mixed in the emerging market economies, with policy decisions mainly driven by the need to support economic activity. Closer to home, the South African Reserve Bank initially reduced the repo rate to 6.5 percent in March but later increased it to 6.75 percent in November 2018 due to elevated upside risks to the medium-term inflation outlook.

Domestic Monetary Policy Implementation in 2018

For its part, the Bank of Botswana 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 Surveys.

As I indicated earlier, monetary policy during 2018 was conducted in an environment of below-trend economic activity and a favourable medium-term inflation outlook. These developments provided scope for maintaining an accommodative monetary policy stance in support of stronger output growth. Therefore, the Bank Rate was unchanged at 5 percent in 2018. Consequently, the prime lending rate of commercial banks was maintained at 6.5 percent, while the deposit rates were, similarly, virtually stable.

Monetary policy was implemented with a view to sustain productive commercial bank lending and monetary operations conducted to ensure alignment of market interest rates with the monetary policy stance. Consequently, given the increase in liquidity that needed to be sterilised, outstanding BoBCs amounted to P8.2 billion in December 2018, an increase from P6.3 billion in December 2017. BoBC yields increased modestly in 2018, reflecting a continuing process of normalisation in the money market interest rate structure.

Global Economic Prospects in 2019

Looking ahead, while global growth remains strong, the pace is moderating. The global economy is expected to grow by 3.5 percent in 2019, lower than estimated expansion of 3.7 percent in 2018. The projected lower growth is premised on anticipated slower expansion in advanced economies, mostly reflecting subdued performance in the euro area. The US GDP growth is forecast to decline from 2.9 percent in 2018 to 2.5 percent in 2019, as the impact of the fiscal stimulus dissipates. Growth in emerging market and developing economies is projected at 4.5 percent in 2019, slightly lower than the 4.6 percent in 2018. Overall, risks to the global economic activity are skewed to the downside, with prospects for escalation of trade tensions, tightening financial conditions, a no-deal Brexit and relatively weaker growth in China presenting key risks to the outlook.

Global inflationary pressures are forecast to be modest in the short to medium term, reflecting below-potential output. In this environment, it is anticipated that monetary policy will remain accommodative in most economies, complemented by measures aimed at facilitating financial intermediation, while fostering resilience of the financial sector, to support growth in economic activity. It is, therefore, notable, that the earlier anticipated monetary policy normalisation (or increase of interest rates) in the advanced countries is being re-assessed and restrained with the advent of generalised weaker economic performance and heightened policy uncertainty.

Domestic Economic Prospects

Distinguished Guests, as the Honourable Minister of Finance and Economic Development indicated in the 2019/20 Budget Speech, the domestic economy is forecast to grow by 4.2 percent in 2019, slightly lower than the estimate of 4.5 percent for 2018. The main factors expected to support growth in economic activity include conducive financing conditions associated with an accommodative monetary policy stance and a sound financial environment. The budgeted 3.6 percent expansion in government spending in 2019/20 and the implementation of initiatives such as the doing business reforms, are expected to further support growth in economic activity and employment creation.

The crawling band exchange rate policy framework has served the country well and will continue to complement monetary policy. This bodes well for maintenance of international competitiveness of domestic industries and macroeconomic stability. As announced at the beginning of the year and broadly consistent with Botswana's trade pattern, the weights of the constituent currencies in the Pula Basket were maintained at 45 percent for the South African rand and 55 percent for the SDR. An annual upward rate of crawl of 0.3 percent of the nominal effective exchange rate is also being implemented in 2019, in order to stabilise the real effective exchange rate.

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 short to medium term. This forecast incorporates the estimated impact of the increase in public service salaries and prospects for continued accommodative monetary conditions. Having said that, it is worth underscoring the point that any upward adjustment in administered prices and government levies and/or taxes and any increase in international commodity prices that is substantially beyond current projections present upside risks to the inflation outlook. In contrast, downside risks to inflation arise from the restrained growth in global economic activity, the tendency of the ongoing technological progress to lower costs and the reduction in commodity prices.

Monetary Policy Stance

Distinguished Guests, based on available data, the current projections suggest that domestic inflation will, in the medium-term, remain within the Bank's objective range of 3 – 6 percent. This favourable medium-term outlook for inflation is in the context of moderate growth in economic activity 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 to households, for welfare enhancements that also drive economic activity. 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 ensuring financial stability and supportive of sustainable economic growth and employment creation.

Conclusion

Honourable Minister and Distinguished Guests, as I conclude, 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, including Government, parastatals and the private sector.

I thank you for your kind attention.