BANK OF BOTSWANA

2022 MONETARY POLICY STATEMENT

by
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Governor

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Introduction

On behalf of the Board, Management and Staff of the Bank of Botswana, I am honoured and most delighted to present the 2022 *Monetary Policy Statement*. I extend a special word of welcome to the Guest of Honour, Honourable Minister of Finance and Economic Development, Ms Peggy Onkutlwile Serame, who, while a veteran of economic policy making in this country, is attending this Launch for the first time in this capacity.

Honourable Minister, I speak on behalf of the Board and the entire staff of the Bank of Botswana, joining the Nation in congratulating you for being the first woman to be at the helm of financial and economic policy management of this Republic as the Minister responsible for finance and economic development. This is particularly significant given that, you assume this role at a time when COVID-19 pandemic has exacerbated Botswana's economic challenges, and when, in many respects, the economy of Botswana is at crossroads. Nevertheless, we at the Bank of Botswana are confident that the roadmap towards the attainment of Vision 2036 growth aspirations and the structural reforms agenda, aimed at transformation of the current growth model towards a more diversified, export and private sector-led, inclusive and resilient economy, is the answer and key to reigniting productivity and export competitiveness. Once again, congratulations, Honourable Minister and thank you very much for gracing this occasion.

Monetary Policy Statement Accountability Themes

Honourable Minister and Distinguished Guests, the publication and launch of the Monetary Policy Statement is an essential element of good governance, transparency and accountability in the formulation and implementation of monetary policy, to anchor policy predictability and credibility. The important tenets, in this regard, are in **five** buckets. The **first** bucket is articulation of the policy framework, encompassing the three elements of objective, instruments, and operations. The **second** bucket is about evaluation of progress on policy performance and impact of the monetary policy framework, that is, with respect to the immediately preceding period, long-term track record and prospects, going forward.

The **third** bucket and related to the foregoing, comprises consideration of capabilities and resources that influence policy effectiveness and impact; the key ones being institutional arrangements, analytical and forecasting integrity, market behaviour, responses, and ingenuity to innovate for policy transmission purposes. The **fourth** bucket is assessment of the global, regional and domestic environment, including emerging trends, scenarios, risks, events and policy response alternatives to be addressed or considered.

The **fifth** bucket is the requirement for clear articulation of prospective developments (for example, influences on price developments) that monetary policy need to pursue and the instruments to be deployed within the policy horizon, to entrench public expectations of low, predictable, and sustainable inflation in the medium term. In this regard, consistent with its primary mandate, the Bank contributes to the maintenance of conducive monetary, credit and financial environment to foster an orderly, durable and balanced economic development and, more specifically, supportive of broader macroeconomic stability.

Factors Affecting Monetary Policy Formulation in 2022

Honourable Minister, I will shortly outline the policy framework and some significant reforms to monetary operations aligned to aspects of these prefacing statements. However, before I do that, I wish to briefly expand on some of the themes I just highlighted as they are critical to the approach to monetary policy formulation and implementation and, also, the rationale and motivation for the operational reforms I will announce today.

First, is that the progressive response to the COVID-19 pandemic appears to have transitioned, or is transitioning, from curtailment of economic activity to growth areas that address the endemic disease situation, for our purposes, health and wellness economics, sectoral realignments, and digitisation, among others; hence the prognosis for positive economic growth prospects, across the globe, going forward. Second, however, are mainly transitional supply-driven, and commodity price increases (some associated with intractable geopolitical tensions) that translate into high inflation. For several countries, inflation has multiplied by factors of two to three within a relatively short space of time; thereby, threatening macroeconomic stability and adversely impacting standards of living. These "cost-push" factors, volatile markets and nascent recovery demand conditions present real challenge for policy making and forward guidance.

Therefore, third, a quicker transition to monetary policy tightening and unwinding of liquidity support measures in many countries, even as fiscal policy remains expansionary, a manifestation of policy rotation; and by the way, this is not necessarily a policy misalignment between fiscal and monetary policies. For emerging markets and developing economies, this policy normalisation, especially by major central banks in developed markets, could lead to undesirable reversal of capital flows, deterioration of debt metrics and foreign exchange constraints and related currency depreciation; in this regard, restraining policy space.

Fourth, is the focus on opportunities and traction of transformation and policy reforms geared towards long term sustainable and impactful policy making and inclusive economic growth. For Botswana, these cover the range of reforms articulated in the Reset Agenda and Economic Recovery and Transformation Plan (ETRP). In the context of the Bank of Botswana, the ongoing legislative review proposes changes to institutional arrangements at the Bank, including a provision for a statutory Monetary Policy Committee that will have external members. Similarly, in addition to a statutory Financial Stability Council, the proposed amendments to both the Bank of Botswana Act and the Banking Act are designed to strengthen institutional and legal capacity for coordinated and effective resolution of any potential systemic financial sector imbalances. As I indicated at the previous launches of the Monetary Policy Statement, the operational reforms (I will shortly announce) are intended to enhance policy transmission and effectiveness, as well as fostering the development of capital markets, particularly the market for government securities.

Distinguished Guests, the objective of the Bank's monetary policy is to achieve price stability, defined as a low, stable and predictable level of inflation within the 3 – 6 percent objective range, in the medium term. What this means is this: in the context of the economy of Botswana, given its structure and level of development, and in order to achieve durable, sustainable and inclusive economic growth, price increases should not persist below 3 percent or above 6 percent.

Monetary policy formulation also considers safeguarding the stability of the financial system. 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. In this regard, price stability, as well as conducive monetary and financial conditions, foster effective mobilisation of savings, productive investment, prudent allocation of credit and international competitiveness of domestic firms. Overall, therefore, the conduct of monetary policy as well as sustained focus on financial stability, support the national policy objectives of employment creation and sustainable economic growth. Price and financial stability also help to preserve the value of incomes and long-term savings, especially for low-income earners and pensioners, with less opportunity or other means to protect the erosion of the purchasing power of their incomes or financial wealth. In essence, the Monetary Policy Statement commits the Bank with respect to its role in contributing to macroeconomic stability and prudent policy making. Hence, the requisite need to respond in a properly calibrated and timely manner to sustained high level of inflation and threats to financial stability.

Overall, while pursuing its policy objectives and mandates, the Bank is committed to ensuring that macroeconomic policies are aligned and, accordingly, the policy choices and responses to promote price and financial stability are undertaken in the broader context and interest of fostering inclusive economic development and a building a broad-based, resilient economy.

Honourable Minister, Distinguished Guests, against the backdrop of this outline of the monetary framework and objectives, I will now address, in turn, first, the global trends that have influenced inflation in Botswana; second, I will report on the conduct of monetary policy in 2021, internationally and here at home; and third, the medium-term inflation outlook and the likely policy stance in 2022. I will, thereafter, outline the reforms to monetary operations I alluded to earlier.

External Economic Developments in 2021

The global economic performance and sentiment strengthened in 2021, amid improving demand resulting from the easing of the pandemic containment measures and consequent opening of economies. The reopening of economies was made possible by the effective roll-out of the COVID-19 vaccination programmes, especially in advanced economies, even as there was uneven distribution and supply of vaccines across the globe. The global economy is estimated to have expanded by 5.9 percent in 2021 from a contraction of 3.1 percent in 2020. However, the pandemic took a turn for the worst in some parts of the world in the second half of the year, with emergence of the new variants, Delta and later in the year, Omicron.

Given the economic recovery that involved imbalance between demand and supply and a surge in commodity prices, inflation increased globally, from an average of 3.2 percent in 2020 to 4.3 percent in 2021; and from 0.5 percent to 5.1 percent for the Special Drawing Rights (SDR) countries and, regionally, from 3.1 percent to 5.9 percent in South Africa. Consequently, the weighted average inflation for Botswana's trading partner countries increased from 1.7 percent in 2020 to 5.5 percent in 2021.

Domestic Economic Developments in 2021

For Botswana, Gross Domestic Product is estimated to have expanded by 8.6 percent in the twelve months to September 2021, compared to a contraction of 7.3 percent in the year to September 2020. This was made possible by a combination of lesser movement restrictions in 2021 compared to 2020, on the back of effective disease containment measures including vaccination programmes; continuing adaptation of economic activity to the COVID-19 environment, accommodative monetary policy and supportive financial conditions.

Domestic inflation was above the objective range of 3 – 6 percent for most of 2021, with average inflation increasing from 1.9 percent in 2020 to 6.7 percent in 2021, largely because of the increase in levies and taxes as well as administered prices during the year and associated second-round effects.

Demand conditions and as, indicated by a negative output gap (the difference between actual and potential output for the economy), were modest and non-inflationary. Indeed, the recent labour force survey results by Statistics Botswana, which reports an unemployment rate of 26 percent, affirms the below-trend output growth. Furthermore, Government expenditure increased marginally by 0.1 percent in the first eleven months of 2021 compared to a decrease of 0.8 percent in the prior year. Within this, public sector personal emoluments rose by 4.4 percent.

The other main driver of demand, growth in commercial bank credit, increased from 4.5 percent in 2020 to 5.1 percent in 2021, as both demand and supply improved due to increased economic activity and prospects. Lending to businesses increased by 2.7 percent in 2021, following a 0.5 percent decrease in 2020. For households, annual credit growth decelerated from 7.3 percent in 2020 to 6.4 percent in 2021, reflecting lower rates of increase in personal and motor vehicle loans.

Global Monetary Policy Implementation in 2021

Honourable Minister, Ladies and Gentlemen, monetary policy implementation in 2021 was generally accommodative at the global level, characterised by maintenance of relatively low policy rates, following the aggressive reduction of interest rates in 2020 in response to the COVID-19 pandemic. However, some central banks, particularly in emerging market economies, increased their policy rates in 2021 responding to the rising inflationary pressures. Moreover, some central banks in the advanced economies signalled that they would tighten policy rates, going forward, to control inflation and, in some cases, taper the asset purchase programmes introduced in 2020 to support the financial sector. Closer to home, the South African Reserve Bank increased the repo rate by 25 basis points to 3.75 percent in 2021 and, by another 25 basis points to 4 percent in January this year, to counter perceived upside risks to the inflation outlook.

Domestic Monetary Policy Implementation in 2021

For its part, the Bank of Botswana continues to conduct monetary policy through a forecast-based policy framework that responds to sustained deviations of inflation from the objective range. The analysis also involves assessment of divergence of actual output from potential output (the output gap), a primary indicator of the direction of future inflation. The forecast incorporates projections of foreign inflation, exchange rates and changes in domestic administered prices and taxes. In addition, the Bank evaluates the 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 quarterly Business Expectations Survey.

Monetary policy in 2021 was conducted in an environment of below-trend economic activity and a favourable medium-term inflation outlook. The increase in inflation was judged to be transitory, of short-term duration and propelled by factors that, except for secondary effects and expectations, monetary policy would have no direct influence. There was, therefore, scope for maintaining an accommodative monetary policy stance in support of stronger output growth. Hence, the Bank Rate was maintained at 3.75 percent, following a cumulative 100 basis points reduction in 2020 to support economic activity that was adversely affected by the COVID-19 containment measures. Consequently, the prime lending rate of commercial banks remained at 5.25 percent. Deposit interest rates generally increased, indicating competition for corporate deposits that are volatile and form an important component of the deposit base for many of the commercial banks.

Outstanding Bank of Botswana Certificates (BoBCs) amounted to P2.3 billion in December 2021, a decrease from P7.8 billion in December 2020, representing a decline in excess liquidity, albeit partly a manifestation of a switch by banks to holding government securities. Foreign exchange sales or externalisation of funds also contributed to the reduction in liquidity in the banking system.

Distinguished Guests, the assessment of financial stability, as contained in the October 2021 Financial Stability Report shows that, despite the adverse effects of the COVID-19 pandemic, the domestic financial system continues to be resilient, characterised by strong capital and liquidity buffers, moderate profitability, generalised institutional strength and good business performance across the industry, as well as being adaptive and innovative. Therefore, the provision of essential financial services in a safe, sound and efficient manner, was sustained during 2021. The enduring stability of the financial system was supported by sound macroeconomic environment, efficient and robust market infrastructure, prudently managed banks, and effective regulation and supervision. Therefore, the financial sector continues to be well-placed and resourced to support economic activity in the recovery phase of the economy.

Global Economic Prospects in 2022

Honourable Minister, Distinguished Ladies and Gentlemen, now looking ahead, that is, prospective economic developments in 2022. Global economic growth is expected to moderate to 4.4 percent in 2022, from 5.9 percent in 2021. However, growth prospects are uneven across regions and reflect uncertain COVID-19 profile and response measures (restrictions and vaccine rollouts), speed and scale of monetary policy tightening and withdrawal of policy stimulus, as well as geopolitical tensions.

Regarding price developments, global inflation is expected to remain elevated in 2022, influenced by prolonged supply chain disruptions, anticipated increase in energy prices and improved global demand conditions as most countries progressively deploy effective COVID-19 vaccines and economies reopen. In this environment, it is anticipated that monetary policy will likely tighten in most economies to control inflationary pressures resulting from pandemic-induced and persistent supply and demand mismatches.

Domestic Economic Prospects in 2022

Honourable Minister, Distinguished Ladies and Gentlemen, the domestic economy is forecast to grow by 4.3 percent in 2022, driven mainly by the continuing recovery of mining activity and improvement in global output. The positive growth prospects are also premised on conducive financing conditions associated with accommodative monetary policy and sound financial environment. In addition, the effective implementation of the ERTP, underpin impetus for positive economic prospects.

Honourable Minister, regarding inflation, the immediate backdrop is that inflation is worryingly high, having risen progressively since the second quarter of 2021, culminating in a reading of 10.6 percent for January 2022. At this level, there is a risk of self-fulfilling expectations of sustained high inflation as manifested in inflation-indexed contract price adjustments, agitation for higher transport fares, negotiations for wage and salary increases, a rise in house rentals and general price increases for goods and services.

To mitigate against this, let me state that inflation is forecast to start moderating from the second quarter of 2022 and, subject to current projections remaining valid, revert to within the Bank's 3 – 6 percent medium-term objective range from the third quarter of 2022. To be absolutely clear, this projected trajectory for inflation is premised on the following. First, the 2 percentage points increase in VAT was a once-off event and will, therefore, fall off from the inflation calculation in 2022. Second, the increase in administered prices announced or estimated for 2022 are no higher than those for 2021 and, therefore, should not result in an acceleration in inflation. Third, domestic aggregate demand remains modest relative to supply. Associated thereto, the projected economic growth, of 4.3 percent in 2022, is below growth potential; and, therefore, output gap remains negative, hence non-inflationary. Fourth, while global inflation is similarly rising, the projected trading partner inflation is within the Bank's objective range of 3 – 6 percent.

Notwithstanding, I should be quick to point out that the risks to the inflation outcome are skewed to the upside. Notably, as I have just indicated, this relates to second round effects and expectations; larger increase in commodity prices (especially energy prices) than currently incorporated in the inflation forecast, particularly emanating from current geopolitical tensions, as the talk of a possible war in Europe intensifies; short-term unintended consequences of import restrictions; and persistence of supply and logistical constraints due to lags in production. Against these, are the downside risks to inflation which include, weaker economic activity than projected, re-emergence of virulent COVID-19 variants (winter months are coming) and resultant restrictions on economic activity, and lower international commodity prices than currently projected.

2022 Monetary Policy Stance and reforms to monetary operations

Distinguished Ladies and Gentlemen, as currently projected, the medium-term outlook for inflation remains favourable and is in the context of moderate growth in economic activity and dissipation of the effects of increase in administered prices and modest impact of external price developments. Ordinarily, this should augur well for maintenance of accommodative monetary policy that supports productive lending to businesses and households. However, given the significant upside risks to the inflation outlook in the short-term and possibility of elevated inflation expectations, the policy posture may need to be calibrated to respond, in an appropriate, timely and measured manner, to price developments in 2022.

Turning to exchange rate policy implementation, 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 are 45 percent for the South African rand and 55 percent for the SDR. A downward rate of crawl of 2.87 percent of the nominal effective exchange rate is also being implemented in 2022, which entails marginal inflationary pressures as the Pula exchange rate depreciates through the downward crawl. Nevertheless, the overriding focus is on maintaining global competitiveness of the domestic industry and support economic growth through maintenance of a stable real effective exchange rate (the composite Pula exchange rate adjusted for inflation differentials).

Here, let me point out that, the exchange rate policy framework is anchored on strong performance and adequacy of the foreign exchange reserves, which have improved slightly from P53.4 billion or 10.1 months of import cover in December 2020 to P57.1 billion or 10.8 months of import cover in December 2021, partly due to recovery in domestic economic performance, as driven by improvement in external demand. Therefore, to the extent that sustainability of the current exchange framework continues to be supported by an adequate level of foreign exchange reserves, the inherent flexibility imbedded in a crawling band exchange rate regime, facilitates adjustments of the rate of crawl of the Pula exchange necessary to generate improvements in international competitiveness of the domestic industry, as may be warranted.

Honourable Minister and Esteemed Guests, as indicated earlier, the Bank continuously evaluates monetary policy implementation framework for effectiveness, as may be necessary. In this respect, during this year, the Bank will introduce further improvements and changes to monetary policy operations with three main objectives.

First, and foremost, to enhance potency of monetary policy transmission and desired market response to adjustments to monetary policy and operations. **Second**, to designate an anchor policy rate capable of affecting liquidity management decisions of banks, and thus providing a direct link to policy changes. **Third,** to achieve an interest rate structure that fosters an active interbank market that also projects the policy stance and desired impact of monetary operations on economy-wide interest rates.

Honourable Minister, these refinements are intended to enhance financial intermediation, reduce costs of monetary operations and improve effectiveness of communicating monetary policy signals. Furthermore, the Bank expects that successful anchoring of these short-term market interest rates to the desired policy stance should also help in the determination of the yield curve for government securities (that is, the cost of financing of budget deficits and infrastructure projects).

In this regard, the Bank will, in the first half of 2022, introduce the reforms to the monetary policy framework as follows: first, the Bank will adopt and designate the yield on the main monetary operations instrument (currently the 7-day BoBCs) as the anchor policy interest rate; it will be called Monetary Policy Rate; replacing the Bank Rate. Second, the auction format for the main monetary operations instrument (the BoBCs) will be changed from the current multiple price system to a fixed rate full allotment system.

Third, an interest rate corridor, with a 200-basis points margin, will be established comprising a new Standing Deposit Facility at the Bank of Botswana at 100 basis points below the Monetary Policy Rate and a Standing Credit Facility at 100 basis points above the Monetary Policy Rate. The decision to want to use both the Standing Deposit Facility and the Standing Credit Facility will be at the discretion of individual clearing banks, that is, banks permitted to have accounts at the central bank.

Fourth, the current intra-day and overnight Credit Facility is retained to accommodate end of day settlement of positions (non-discretionary), currently set at 3.75 percent.

Fifth, the Bank will, on a less frequent basis (two to three times within the Primary Reserves Averaging maintenance period), depending on the liquidity situation, undertake liquidity absorption or injection at the policy rate.

Sixth, the Bank will introduce a one-month paper (BoBC), auctioned once a month, that will help address some of the structural liquidity positions and support the construction of the short-end of the yield curve, especially since government treasury bills are not issued for this tenor.

Finally, in order to foster the development of a competitive financial sector, the Bank considers it prudent to allow commercial banks to independently determine their own Prime Lending Rates (PLR). However, to ensure an orderly and smooth transition as well as treatment of pricing of existing financial contracts and other products linked to industry prime lending rate, the current PLR of 5.25 percent should not be changed by any bank except in the event of an adjustment by the Monetary Policy Committee of the signalling policy rate, as I indicated to be called the Monetary Policy Rate.

Given the scale of the reforms, the Bank will henceforth engage the relevant stakeholder community to ensure a smooth transition and implementation of these monetary operations reforms towards the intended objectives. Moreover, as well as embedding the operational processes around these reforms, the Bank will continue to project its communication capabilities and instruments to convey the messages relating to economic and financial developments; the main drivers of inflation and anticipated profile and trajectory, including estimation of the difference between potential and actual output; and how this evaluation informs the rationale for monetary policy action or posture.

Conclusion

As I conclude, Honourable Minister and Distinguished Ladies and Gentlemen, I wish to underscore that success in achieving price and financial stability, to which the Bank remains fully committed, calls for the cooperation of all key players in the economy. This time around, let me single out banks as key transmitters of monetary policy impulse and with responsibility for ensuring smooth implementation of the monetary operations reforms I have just announced. In addition, in a period of elevated inflation, all other stakeholders, are expected to moderate their inflation expectations in deference to the regular communication by the Bank on inflation profile. Market analysts and the media would be particularly helpful in this regard.

To summarise, while I have said so many words in the past half hour or so, the overriding message is that the Bank stands ready, as always, to play its part in contributing to monetary and financial conditions necessary for sustainable economic growth and welfare enhancement.

Honourable Minister, Distinguished Ladies and Gentlemen, I thank you for your kind attention.