BANK OF BOTSWANA

2021 MONETARY POLICY STATEMENT

by

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Governor

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On behalf of the Board, Management and Staff of the Bank of Botswana, I am honoured and most delighted to present the 2021 *Monetary Policy Statement*. This year, however, due to the COVID-19 pandemic, which has disrupted the traditional ways of functioning, the launch of the Statement is virtual.

Honourable Minister, Distinguished Ladies and Gentlemen, notwithstanding the challenges we are facing or indeed, because of the reality of uncertainty and periodic episodes of high impact events, the publication and launch of the Monetary Policy Statement remains an important feature of policy making in the Bank's calendar of events. It is a key aspect of good governance, transparency and accountability in the formulation and implementation of monetary policy. The challenges we are currently confronted with happen to reinforce the criticality of these basic tenets of policy making and good governance.

The Bank, through the Monetary Policy Statement, seeks to promote an understanding of the monetary policy framework and its objectives. The ultimate aim is to guide the public's inflation expectations towards convergence with the Bank's inflation objective and, therefore, enhancing prospects for sustained 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 posture in the year ahead.

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 3 – 6 percent, in the medium term. Monetary policy formulation is also aligned to safeguarding stability of the financial system. In this regard, price stability, as well as 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 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 savings.

COVID-19 Implications for Policy Making

In essence, the Monetary Policy Statement commits the Bank with respect to its role in contributing to macroeconomic stability and prudent policy making. This is particularly propitious in the advent of the COVID-19 pandemic which, in addition to the devastating impact on economic activity and livelihoods, could challenge the resilience and efficacy of conventional policies and lead to inadvertent disruption or destruction of otherwise good and time-tested policy frameworks and rules.

In the circumstances, the Bank believes that to surmount and live through the crisis without engendering long-term damage, it is important to, first, have the fortitude to not allow a crisis destroy hitherto a track record of prudent policy making, solid institutional frameworks and, in general, governance architecture, which could have lasting adverse effects on policy integrity, credibility and economic performance. Second, to have the foresight and agility to not waste a crisis, as the saying goes; that is, ability to seize the window of opportunities engendered by the crisis to undertake structural and policy reforms.

In the context of the Bank, this relates to prospects for enhancements of policy transmission and effectiveness, as well as fostering the development of capital markets, particularly the market for government securities. Related thereto, the potential and ability to respond expeditiously and meaningfully to adverse developments is also fostered by preparedness in terms of policy space and frameworks, clear institutional responsibilities, as well as the state of the banking or financial system generally. I will, later on, outline the specific measures that were undertaken by the Bank against the background of this state of preparedness.

Overall, while pursuing its policy objectives and mandates, the Bank is committed to ensuring that macroeconomic policies are congruent and, accordingly, the policy choices and responses are positive for immediate stabilisation and, also, sustainable in terms of long-term impact on economic development and resilience; including soundness and stability of the financial system.

Honourable Minister, Distinguished Guests, let me now revert to the established structure of the Monetary Policy Statement and address, in turn, first, the global trends that have influenced inflation in Botswana; second, highlights of the conduct of monetary policy, internationally and here at home; and, third, the medium-term inflation outlook and outline the likely policy stance in 2021.

External Economic Developments in 2020

Global economic performance and sentiment in 2020 were negatively affected by the outbreak and spread of the COVID-19 virus. Therefore, global Gross Domestic Product (GDP) declined by an estimated 3.5 percent in 2020 compared to an expansion of 2.8 percent in 2019. The contraction markedly surpasses the 0.1 percent contraction in the 2008/09 global financial crisis and is the worst since the Great Depression of the 1930s. For the first time, all regions experienced negative growth and China, which registered positive growth, was an exception among the major economies, helped by relatively early effectiveness of disease containment measures.

Given the economic contraction, inflation generally fell globally; the average for the world eased from 3.5 percent in 2019 to 3.2 percent in 2020; and from 2 percent to 0.5 percent for the SDR countries and, regionally, from 4 percent to 3.1 percent in South Africa. Consequently, weighted average inflation for Botswana's trading partner countries decreased from 2.9 percent in 2019 to 1.7 percent in 2020.

Domestic Economic Developments in 2020

For Botswana, output contracted by 6.4 percent in the twelve months to September 2020, compared to an increase of 3.7 percent in the year to September 2019. Both mining and non-mining production fell, mainly resulting from the impact of the COVID-19 pandemic containment measures. Mining output declined significantly by 21.9 percent in the year to September 2020, compared to a 1.4 percent growth in the year to September 2019. During the same period, non-mining GDP contracted by 4.7 percent compared to a growth of 3.9 percent in the corresponding period in 2019.

Domestic inflation was below the lower bound of the objective range of 3 – 6 percent in 2020; and the outcome was broadly consistent with earlier projections. Average inflation decreased from 2.8 percent in 2019 to 1.9 percent in 2020, largely because of the decrease in domestic fuel prices which was more pronounced relative to the increase in electricity tariffs, public transport fares and postal tariffs in the same year. Overall, low inflation in Botswana was in the context of restrained domestic demand pressures and subdued foreign inflation. Notably, and in contrast to the overall trend, food price inflation accelerated from 3 percent in December 2019 to 3.6 percent in December 2020.

Among the domestic demand factors, Government expenditure contracted by 10.1 percent in the first eleven months of 2020 compared to an increase of 15.4 percent in the prior year. Within this, personal emoluments rose modestly by 2.6 percent, following the September 2020 public sector salary increase, initially deferred due to economic challenges exacerbated by the COVID-19 - pandemic.

The other main driver of demand, growth in commercial bank credit, eased from 7.6 percent in 2019 to 4.5 percent in 2020, as both demand and supply were restrained due to reduced economic activity and uncertain prospects. Lending to businesses contracted by 0.5 percent in 2020, following a 1.7 percent decrease in 2019. For households, annual credit growth decelerated from 13.7 percent in 2019 to 7.3 percent in 2020, encompassing lower rates of increase for personal and mortgage loans.

The subdued pressure on inflation in Botswana is also apparent from below-trend economic activity, signified by a negative output gap, as the economy continues to operate below-potential. At the same time, the recent labour force survey results by Statistics Botswana, which reports an unemployment rate of 24.5 percent, reinforces the assessment of below-potential performance of the economy, hence restrained aggregate demand and, consequently, subdued pressures on inflation.

Global Monetary Policy Implementation in 2020

Honourable Minister, Ladies and Gentlemen, monetary policy implementation in 2020 was generally accommodative at the global level, characterised by countercyclical policy measures aimed at stimulating economic activity. These measures were also necessary to forestall possible lasting economic devastation as well as preparing ground and creating conducive conditions for durable economic recovery.

Therefore, most central banks, in both advanced and emerging market economies, aggressively reduced their policy rates and, in some instances, expanded or launched asset purchase programmes to support the financial sector. For example, closer to home, the South African Reserve Bank reduced the repo rate by a cumulative 325 basis points to 3.5 percent in 2020 to support economic activity in that country.

Domestic Monetary Policy Implementation in 2020

The background to policy implementation in Botswana is that, as a small, open economy that is integrated with regional and global economies, the country's export earnings fell considerably as a result of the adverse impact of the COVID-19 pandemic on economic activity, notably mining, tourism and hospitality industries and services. At the same time, the necessary disease containment measures, globally and domestically, significantly disrupted supply chains and implementation of planned projects, such as construction.

These measures throttled economic activity, with devastating effect on employment, incomes and, in general, social welfare. In turn, the resultant weak economic performance, combined with measures adopted by Government to support firms in hard-hit sectors, such as wage subsidies and deferral of some tax payments, led to a significant weakening of the fiscal position and external buffers. Against this background, the Bank's policy responses, within its mandate, contributed to immediate stabilisation and support for economic activity, reform efforts and long-term structural transformation initiatives.

As I alluded to earlier, at the start of the pandemic, there was ample space for monetary policy easing. Monetary policy was conducted in an environment of a deep global recession, external trade shock and weak commodity prices, notably diamond exports and weak or below-trend non-mining output, as well as a positive outlook for inflation. For the entire 12-months period to December 31, 2020, domestic inflation was below the lower bound of the medium-term objective range of 3 – 6 percent; and forecast to remain within the objective range in the medium term. Second, given the prevailing level of interest rates, there was scope for reduction of the policy rate without encountering constraints to transmission. Third, the Bank had the latitude to improve access to liquidity by commercial banks through a variety of available instruments; and fourth, like in most other jurisdictions and in contrast to the

2008 global financial crisis, the banking sector and, indeed, the broader financial sector were in a strong position.

In the circumstances, and in recognition of the short-term adverse developments in the domestic economy due to the COVID-19 pandemic, and also taking into account the anticipated disinflationary pressures from the below-trend economic performance in the medium term, the Bank implemented several measures to avert or alleviate the prospective adverse economic fallout.

Specifically, in order to pre-empt liquidity constraints that could be engendered by the adverse impact of the COVID-19 pandemic on the economy and financial markets, in April 2020, the Bank introduced a number of measures to enhance access to liquidity by commercial banks. In this regard, the cost of accessing overnight funding by licensed banks from the Bank of Botswana Credit Facility was reduced by doing away with the punitive 6 percentage points above the Bank Rate that hitherto prevailed. In addition, repo facilities that were available only on overnight basis were extended and offered against eligible securities with maturity of up to 92 days.

Furthermore, the collateral pool for borrowing by licensed commercial banks from the Bank of Botswana was extended to include all corporate bonds listed and traded on the Botswana Stock Exchange, subject to completing regulations and arrangements relating to valuation (haircuts) and acceptable custody arrangements. The Bank also reduced the minimum regulatory capital adequacy ratio from 15 percent to 12.5 percent of risk-weighted assets, to provide additional capacity for banks to support economic activity.

Regarding monetary policy conduct during the year, the Bank Rate was cut by a cumulative 100 basis points from 4.75 percent to 3.75 percent. The Bank also reduced the primary reserve requirement (PRR) from 5 percent to 2.5 percent, which injected P1.6 billion into the banking system and allowed commercial banks to be unconstrained in performing financial intermediation to support economic activity.

Here, I would like to acknowledge the gesture and responsiveness of the banks in offering their customers in the affected sectors, loan repayment holidays for periods of up to six months, restructuring of credit facilities to ease repayment burden and, in the case of insurance companies, moratorium on payment of policy premiums without the risk of loss of benefits.

Regarding other measures, in order to foster the conduct of transactions and payments in the advent of movement restrictions and social distancing protocols, the daily limits for mobile money operators were raised to double the hitherto prevailing levels and overall limits were also substantially increased. Related thereto, commercial banks offered their customers discounts on fees and other charges for digital transactions and remote banking channels.

Overall, the policy measures and initiatives by the Bank were aimed at providing support to economic activity, in particular, to ease the cost of borrowing, improve the cash flow position and balance sheets of both businesses and households, and to anchor demand during the recovery phase of the economy.

In terms of market response, short-term interest rates, including BoBC yields, generally decreased, reflecting the reduction in the Bank Rate. The prime lending rate of commercial banks declined from 6.25 percent to 5.25 percent. The liquidity position and market activity were largely stable in the context of some certainty about access to liquidity. Outstanding BoBCs amounted to P7.8 billion in December 2020, a decrease from P8.6 billion in December 2019, associated with substitution into government securities and foreign exchange sales.

Distinguished Guests, as I indicated last year, the Bank continuously evaluates the monetary policy framework and monetary operations for effectiveness and introduces refinements where necessary. In that regard, the Bank discontinued the issuance of the 91-day BoBCs effective October 2020, as the Government reintroduced the 3-month Treasury Bill (T-Bill). This was against the background of the increase of the ceiling of the government bond issuance programme, from P15 billion to P30 billion.

The discontinuation of the issuance of the 91-day BoBCs has at least two benefits. First, it eliminates competition with the 3-month T-Bill and, therefore, supports the building up of the Government T-Bill market. Second, it allows for a clear separation between monetary policy operations and public sector debt management, in line with best international practice. It is also worth noting that since the introduction of the Primary Reserve Requirement Averaging in 2019, most commercial banks continued to actively use this instrument as a tool for effective management of liquidity.

Furthermore, as I announced in the 2020 Monetary Policy Statement, the continuous evaluation of the policy framework also involves, among others, the assessment of the choice of anchor policy rate between the Bank Rate and the operating BoBC stop-out yield. In particular, this is with respect to the relative efficacy in terms of the impact of changes thereto on the market and, potentially, policy transmission. There have been extensive consultations with the stakeholder community in this regard and the evaluation towards a possible change is ongoing. The remaining work entails further qualitative and quantitative impact assessment of possible transitional disruption to the benchmark pricing framework for existing credit facilities, endowment effects and other financial contracts.

Distinguished Guests, I am also pleased to report that the financial stability assessment, as indicated in the October 2020 Financial Stability Report concluded that, notwithstanding the challenges engendered by the onset of the COVID-19 pandemic, the domestic financial system remains resilient, characterised by strong capital and liquidity buffers as well as relatively low default rates or non-performing loans. The enduring stability of the financial system was supported by a sound macroeconomic environment, efficient market infrastructure, effective supervisory frameworks and prudent risk management by banks. Therefore, the financial sector continues to be well-placed and resourced to support economic activity, both during the current challenging times and prospective recovery phase of the economy.

Global Economic Prospects in 2021

Honourable Minister, Distinguished Ladies and Gentlemen, now looking ahead, the global economy is expected to rebound to growth of 5.5 percent in 2021, from a contraction of 3.5 percent in 2020. The projection is premised on expectations of successful deployment of effective COVID-19 vaccines, as well as maintenance of supportive fiscal and accommodative monetary conditions. Key upside risks to the outlook include further favourable outcomes on COVID-19 vaccine manufacturing, distribution and effectiveness of containment measures, generally. However, there are enduring significant downside risks to economic prospects.

Among others, there is the possibility of resurgence of disease outbreaks in places that had gone past peak infections; second, the threat of mutation and emergence of more problematic variants of the coronavirus; third, the logistical problems relating to the procurement and distribution of COVID-19 vaccines particularly in emerging markets and developing economies; fourth, the likelihood of more severe and longer-lasting effects of the pandemic on potential output; and fifth, the possibility of financial stress triggered by high debt levels and anaemic growth.

Regarding price developments, global inflation is expected to pick up in 2021, reflecting the anticipated recovery in commodity prices, in particular, international oil prices, and global demand as most countries roll-out effective COVID-19 vaccination programmes. However, 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.

Domestic Economic Prospects in 2021

Honourable Minister, Distinguished Ladies and Gentlemen, the domestic economy is forecast to grow by 8.8 percent in 2021, largely a reversal of the estimated contraction of 7.7 percent in 2020. The improvement is premised on conducive financing conditions associated with accommodative monetary policy and a sound financial environment. In addition, the mid-term review of the National Development Plan 11, supported by effective implementation of the Economic Recovery and

Transformation Plan, provides added impetus for positive economic prospects.

Overall, both external and domestic pressures on inflation are expected to be benign, and it is projected that inflation will revert to within the Bank's 3 – 6 percent medium-term objective range from the second quarter of 2021. The forecast incorporates the announced increase in value added tax, fuel levy, electricity tariffs, Botswana Housing Corporation rentals, as well as the introduction of sugar tax. The forecast also takes into account the likely impact on domestic fuel prices of the expected increase in international oil prices, the anticipated strengthening of commodity prices generally, the upward revision in the South African inflation forecasts and the base effects associated with the decrease in fuel prices in 2020.

Having said that, I should be quick to caution that any upward adjustment in administered prices and government levies and/or taxes that has not yet been announced, accelerated implementation of the Economic Recovery and Transformation Plan, aggressive action by governments and major central banks to bolster demand 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 prospects of weak domestic and global economic activity and implementation capacity constraints that could hinder the effectiveness of policy stimulus and the Economic Recovery and Transformation Plan initiative, resulting in low inflation.

2021 Monetary Policy Stance

Distinguished Ladies and Gentlemen, based on available data, the current projections suggest that domestic inflation will, in the short term, revert to and remain within the Bank's medium-term objective range of 3 – 6 percent, but move closer to the upper bound. The overall 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 households, potentially resulting in welfare enhancements that also drive economic activity. The 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 durable financial stability and support sustainable economic growth and employment creation.

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 2021. With low inflation, the policy framework allows flexibility to loosen real monetary conditions through a downward rate of crawl to enhance global competitiveness of the domestic industry and support economic growth.

This exchange rate policy framework is anchored on strong performance and adequacy of the foreign exchange reserves, which have, however, recently fallen from P65.2 billion or 12 months of import cover in December 2019 to an estimate of P53.4 billion or 10 months of import cover in December 2020, due to the adverse impact of COVID-19 on domestic economic performance. Thus, the importance of the flexibility inherent in the exchange rate framework that facilitates adjustments necessary to generate improvements in international competitiveness of the domestic firms and, therefore, better balance of payments outcomes that support maintenance of adequate level of foreign exchange reserves, necessary to cushion the economy against adverse economic developments.

Conclusion

In concluding Honourable Minister and Distinguished Ladies and Gentlemen, I wish to underscore that, the continuing success in achieving price and financial stability, 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. The other point to conclude with is that, given that monetary and fiscal policies are purposefully expansionary to boost prospects for economic recovery, immediate and effective implementation of transformation initiatives and structural reforms by all involved would be critical to raising prospects for faster and inclusive growth as well as economic diversification. Furthermore, the redesign of industrial and trade policies to promote exports, transition towards digital economy, greater financial inclusion and broader participation by all segments of society in productive economic activities, should result in fast tracking the recovery, as well as enhancing economic resilience and moving the economy to a high-income status.

In this regard, the onus for effective implementation is not on Government alone. It is on the public sector broadly, including parastatals and development finance institutions, as well as a more innovative and dynamic private sector. In the private sector, this includes all those designated and awarded government contracts and project implementation roles and those that benefit from funding and other support by the public sector.

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