

## Bank of Botswana

### *Curriculum Vitae*



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# **BOTSWANA'S MONETARY POLICY FRAMEWORK**

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The views expressed in this paper are solely those of the authors, and do not necessarily reflect those of the Bank of Botswana or any other member of its staff.

## **BOTSWANA'S MONETARY POLICY FRAMEWORK**

### **1. Introduction**

1.1 Contemporary monetary policy focuses on attaining and maintaining price stability to support sustainable and balanced economic growth. In many instances the monetary policy framework encompasses clear and publicly disclosed objectives and targets while policy is operated in a liberalised environment. Nevertheless for a number of countries, there has been a long period of transition from alternative frameworks that involved direct controls on interest rates, exchange rates and credit mainly geared towards supporting development objectives. The following section discusses past monetary operation in Botswana and its motivation while section three examines the reasons for adopting a new policy framework in the early 1990s. Section four details elements of the current monetary policy framework and section five examines the success of monetary policy in achieving its targets and desired objectives. This is followed by a conclusion in section six.

### **2. Background and historical perspective**

2.1 Although Botswana gained political independence in 1966, it remained part of the Rand Monetary Area, which included South Africa, as the dominant partner, Lesotho, Swaziland and South West Africa (now Namibia), until 1976. This arrangement entailed the use of a common currency, the South African rand, as well as monetary policy being undertaken from South Africa. Botswana attained monetary independence and set up its own central bank in 1976. At the time the discharge of monetary policy was in the context of legislated administration of interest rates, credit controls and exchange controls.

2.2 The **Botswana National Development Plan 6, 1985 - 91** spells out the broad objectives of monetary policy in Botswana, following monetary independence. These were supporting the balance of payments; maintaining a liberal foreign exchange regime; and avoiding sharp shifts in aggregate demand (Government of Botswana, 1984). The monetary policy stance was particularly influenced by a recognition of Botswana's vulnerability in two areas. First, on the one hand, there was instability on the political front in Rhodesia (now Zimbabwe) and South Africa, two of its neighbours with which it had the most substantial economic links. At the time, both these countries were subject to political and economic sanctions which inevitably affected economic activity in Botswana. On the other hand, there was uncertainty regarding the action each of these countries might take against Botswana, given its apparent sympathy with the liberation movements in these countries (although it was not actively involved in the conflicts then going on). Second, reliance on export earnings from a limited number of commodities rendered the economy vulnerable to adverse production and market shocks affecting these products<sup>3</sup>. It was, therefore, considered necessary that monetary policy play a role in supporting an increasing accumulation of foreign exchange reserves. The foreign exchange reserves would in turn enable a liberal foreign exchange environment facilitating unrestricted imports and a perception of investor friendliness (Government of Botswana, 1984, 1991; Hermans, 1996).

2.3 Monetary policy was also concerned with sharp shifts in aggregate demand where the focus was on avoiding excessive credit creation due to balance of payments surpluses and guarding against demand pull inflation. The operating instrument used to achieve this was the interest rate. However, for the most part prior up to the late 1980s, monetary policy was not inspired by a need to control monetary aggregates with a view to containing demand pressure (except in 1981 when credit ceilings on bank lending were imposed due to the deteriorating balance of payments situation at the time). It is fair to say that rather than a need to control credit expansion, the perception was that not enough credit was advanced to the productive private sectors. Whereas there had on occasions been a rapid expansion of the money supply, for the most part this was effectively sterilised, through creating deposit facilities at the Bank of Botswana and the fact that most of the funds belonged to the government and were deposited at the central bank.

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<sup>3</sup> Immediate examples at the time included the effect on beef exports of Foot and Mouth Disease and the production and marketing problems of the copper-nickel mines.

2.4 However, given the surplus budget position for virtually all the years since monetary independence and sufficient financial saving to finance occasional budget deficits, there were no inflation pressures arising from excessive government borrowing (Rajalingam, 1987; Bell, 1987). Thus, the government had little need to resort to domestic debt and did not have any need to choose between tight fiscal policy and borrowing from the central bank (Harvey 1997: 70).

2.5 The conduct of monetary policy was nevertheless affected by the prevalence of excess liquidity and the limited range of monetary policy instruments available. Except for the interest rate, the traditional monetary policy instruments, such as open market operations and bank reserve requirements, were not readily available to the Bank of Botswana or were not effective in an environment of excess liquidity. The absence of any lending function by the central bank, either directly or as a lender of last resort to the banking system, meant that the standard approach of changing the rate (Bank Rate) at which the central bank would offer assistance to commercial banks through its discount window would have little effect on the economy. Reserve requirements and the Bank Rate could not be effective in influencing the banks' lending behaviour because the banks held reserves well in excess of the required amount and had no need to borrow from the central bank. However, both the Bank Rate and primary reserve and liquid assets requirements<sup>4</sup> were available for use by the Bank of Botswana. Although not actively used (given the excess reserves of the banks) the Bank Rate was varied when changes were made to the deposit and lending rates of commercial banks to maintain an appropriate structure; i.e. a higher cost of borrowing from the central bank than the rate banks paid on deposits.

2.6 Operationally, monetary policy focused on the influence of the structure of interest rates on credit demand and saving (Rajalingam, 1987). Generally, during this period, interest rates were adjusted downwards in order to alleviate the cost of borrowing, and thus, to stimulate investment. By contrast, increases in interest rates were aimed at reinforcing credit restraint, preventing capital outflows/and or encouraging capital inflows, and as a means of providing a positive real rate of return to domestic savers (Government of Botswana, 1984; Hermans, 1996). It is, however, the case that the need for a lower cost of credit was usually considered more important. Thus, interest rates in Botswana have been low and negative in real terms for most of the period up to 1993.

2.7 The exchange rate policy was occasionally used to reduce the impact of imported inflation (mainly inflation in South Africa). Given the favourable foreign exchange reserves and the preponderance of imports in the consumption basket, it was possible to revalue the currency with the explicit aim of alleviating the impact of foreign inflation. Notably, the Pula appreciated from R1,00 to R1,37 between 1976 and 1990, when consumer prices in Botswana rose 4,3 times while those in South Africa rose 6,2 times (and the bilateral real exchange rate did not rise) (Harvey 1997: 70).

### **3. Reasons for adopting a new monetary policy framework**

3.1 Botswana began moves towards a new market-oriented monetary policy in the early 1990s in the context of financial liberalisation, motivated by a number of considerations. There was, first, concern with achieving robustness and flexibility of instruments of monetary policy; second, a perception of limited financial sector development (hence inefficient intermediation), third, need to achieve and maintain competitiveness vis-à-vis other liberalising developing economies; and, fourth, concern with the potential impact of present policies on future growth. It was considered that in future sustainable growth would derive from a diversified economy. Diversification would in turn be fostered by continuing macroeconomic stability and the ability of the economy to retain and attract inward investment. However, there was a particular concern with excess liquidity in the financial system which impacted on the operation as well as the effectiveness of monetary policy.

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<sup>4</sup> The liquid asset requirement was in practice more of a prudential requirement than a monetary policy instrument.

## **3.2 Excess liquidity and its effects on policy operation**

3.2.1 In any financial market the existence of excess liquidity would normally lead to a fall in the price (interest rate) until the demand equalled supply. Given a relatively high rate of inflation, the fall in the interest rate may be such that it becomes less attractive to deposit funds with the domestic financial institutions. In the context of exchange controls, under which the government centralises foreign asset holding, savers suffer a foregone opportunity to earn higher returns in international markets. However, while liquidity conditions force interest rates down and inflation remains higher, the demand for credit can, theoretically, be expected to rise until the excess commercial bank funds are eliminated. Such an increase in credit in the context of negative real lending rates may have deleterious effects on the economy.

3.2.2 In the case of Botswana, it would seem that for most of the time effective demand for credit was limited. However, during the period 1988 - 1992 there was a surge in demand for credit, to some degree attributable to two factors (Bank of Botswana, 1993; Hermans, 1996). First, incentives were created by government to increase home ownership in the urban centres. This encompassed an accelerated delivery of serviced land and government guarantees (up to 95 per cent) for mortgages. Second, emerging competition in the banking sector resulted in an increase in the range as well as better marketing of specialised loan schemes, targeted especially at salaried individuals. As a result of these developments, there was a surge in credit, especially to the household sector. As documented in Bank of Botswana (1993; 1996) and Hermans (1996), three notable outcomes were apparent. First, a bubble developed in the housing market, including an increase in construction costs which fed into the general price level. Second, as the bubble burst, subsequent problems with servicing the loans became apparent, and then worsened when interest rates were later increased, weakening the loan portfolios of the lending institutions. Third, there was a faster increase in consumption loans (to households) compared to productive lending (to businesses and industry), given the lower appraisal costs and risks associated with lending to regular income earners as opposed to businesses. In the event the authorities decided to take action to reduce the rate of credit expansion, through influencing an upward increase in interest rates. It was, however, proving increasingly difficult to achieve this given the excess liquidity and significant amount of lending being undertaken outside the commercial banking system.

3.2.3 The authorities, therefore, needed to mop up the excess liquidity in order to have some control over credit expansion. Possible ways to reduce the excess liquidity included relaxing foreign exchange controls and allowing the private sector and parastatals to hold foreign assets. It has, however, been argued that the scale of excess liquidity did not necessarily result from the failure to recycle available resources, given the exchange controls. On the contrary, it was perceived to be indicative of prudent and efficient utilisation of resources (Government of Botswana, 1984; 1991; World Bank, 1989). The World Bank (1989), for example suggested that, taking a multi-year perspective, when the increase in income is perceived as temporary (by a household, firm or country), it is desirable to set aside part of such resources for future uses in order to achieve an optimal inter-temporal allocation of resources. In the context of Botswana, the resources flowing from the diamond boom were not expected to continue beyond a few years. Further, the ability of the economy to absorb these resources productively has always been limited, due to non-financial factors. In the light of these considerations eliminating excess liquidity would not itself be a goal of monetary policy. However, to ensure control over monetary instruments and a desired outcome in terms of movements in interest rates, it was essential for the authorities to be able to absorb the excess liquidity in the market. Further, it was important that the impact of policy be spread across all the lending institutions, including the development finance institutions.

## **4. Current monetary policy framework**

4.1 In the current policy framework interest rates and exchange controls have been fully liberalised and banks are free to set their own deposit and lending rates as well as there being free movement of capital save for a limitation with respect to foreign portfolio investment which is limited to 70 per cent of funds. Further, foreign entities cannot purchase the central bank securities (which are a means of mopping up liquidity; see below) used in open market operations. The exchange rate, by contrast, is fixed to a basket of currencies comprising the rand and the SDR,

and thus varies in line with movements in these currencies and to the extent of the weight of each in the basket. The monetary policy framework, including objectives, targets, operation and transmission mechanism is discussed below.

## **4.2 Objectives**

4.2.1 There are two principal objectives of monetary policy in Botswana. The first objective is to ensure price stability as reflected in a low and stable rate of inflation, over the medium to long term. Significantly, in the current framework a level or range is not publicly specified. However, given the forecasting framework the authorities determine a desired inflation rate necessary to avoid real exchange rate appreciation.

4.2.2 The second objective is to maintain positive real interest rates comparable to those prevailing in major international financial markets and for comparative purposes, these are the United Kingdom, USA and South Africa. With a liberal exchange rate regime and an open capital account as well as the fact that Botswana is increasingly integrating into the global economy, the achievement of comparable real rates of interest is important in order to avoid large capital outflows in search of higher returns in international markets.

## **4.3 Influences on Botswana's inflation<sup>5</sup>**

### **Imported inflation**

4.3.1 The Botswana economy is relatively open, with imports accounting for an average of 40 per cent of GDP over the past five years. Imported tradeables account for 47 per cent of the Consumer Price Index (CPI) basket<sup>6</sup>. Hence imported price rises have a significant influence on domestic inflation. Approximately 80 per cent of imports originate from neighbouring South Africa, and so that country's inflation rate is the most immediate influence. However, broader international inflation is also important, whether through direct imports from the rest of the world, or indirectly for products imported through South Africa.

4.3.2 The exchange rate of the Pula is fixed, with the currency pegged to a basket of currencies comprising the South African rand and the SDR, with the weights broadly reflecting trade patterns. The exchange rate against the basket is adjusted from time to time in order to achieve the objective of a stable real effective exchange rate. This policy has tended to keep the Pula fairly closely linked to the rand. However, the periodic instability of the rand (and hence the Pula) against the SDR currencies has exacerbated the impact of inflation from the rest of the world. The exchange rate has not been actively used as a measure to constrain imported inflation, largely because of concerns that excessive nominal appreciation against the rand would lead to real appreciation, reflecting adjustment lags and an incomplete transmission (at least in the short term) of exchange rate changes to domestic prices.

### **Administered prices**

4.3.3 A significant proportion of goods have administered prices, particularly domestic non-tradeables. These include rentals on public housing; power, water and telecommunications tariffs; public transport fares; charges for public services, such as health care; and petroleum and related products<sup>7</sup>. Some of these administered prices are characterised by large and infrequent price changes, which tend to introduce an element of volatility into the inflation rate.

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<sup>5</sup> This section, as well as Figures 1 and 2, was extracted from an internal Bank of Botswana document prepared by Dr K Jefferis (Deputy Governor, Bank of Botswana).

<sup>6</sup> Domestic tradeables and non-tradeables account for 24 per cent and 29 per cent each.

<sup>7</sup> Domestic tradeables and non-tradeables account for 24 per cent and 29 per cent each.

#### **Aggregate demand pressures**

4.3.4 Botswana has experienced rapid economic growth, with real GDP growth averaging over 10 per cent a year during the 1970s and 1980s, although it has recently been somewhat lower, averaging 5 per cent a year during the 1990s. This growth has largely been export driven (in particular diamond exports, which account for around 75 per cent of total exports). However, the diamond sector operates as a relatively isolated enclave in economic terms, and fluctuations in the level of output and export earnings have little direct impact on the rest of the economy. The main channel through which diamond exports are linked to the rest of the economy is through the government; it is only to the extent that government spends the revenues that it receives from the minerals sector that aggregate demand is affected.

4.3.5 As the high rates of GDP growth indicate, aggregate supply capacity has grown rapidly. Nevertheless there is concern that major fiscal injections cause demand to outstrip supply, and hence generate inflationary pressures. Government is an extremely important economic agent, with government spending accounting for some 40 per cent of GDP. Growth rates of government spending in excess of 20 per cent a year (more than 10 per cent in real terms) are not uncommon, and much private consumption (and investment) tends to be driven by government spending. In recent years, particularly large demand injections from government have come in the form of public sector pay rises (which tends to lead to generalised demand and credit growth) and from spending on development projects (schools, roads, water and sanitation, etc.), which tends to impact most heavily on the construction sector. Fortunately, the openness of the economy provides an outlet for domestic demand pressures. Free trade with South Africa, plus the relatively large size of that country's economy relative to Botswana, means that imports of both intermediate and final consumption goods and services can rise quickly to meet demand growth without any impact on prices at source. However, there is some concern that a lack of competition in the commercial sector in Botswana means that mark-ups can be raised when demand is growing rapidly, and hence contribute to domestic inflation (at least temporarily). There is also concern that construction costs tend to rise rapidly when there are major development projects taking place, and it is also noticeable that property prices (including rentals) are volatile, given the very slow responsiveness of supply to changes in demand.

#### **4.4 Intermediate targets and monitored/tracked variables**

4.4.1 In recognition of the fact that monetary operation does not usually affect the ultimate targets directly, the intermediate targets that are tracked or whose movements are directly linked to policy change as a transient measure towards achieving the ultimate target, are the annual rate of growth of domestic credit and growth in government expenditure. The authorities also monitor developments in the Pula exchange rate vis-à-vis the South African rand and the international hard currencies as well as inflation in South Africa, the main trading partner, which have an impact on domestic inflation.

##### **Growth rate of credit to the private sector**

4.4.2 The rate of credit expansion is considered to be one of the major factors that generate demand pressures and to the extent that it is excessive can be inflationary. The authorities therefore estimate a target range of credit growth that is sufficient to support a sustainable rate of real economic growth as well as accommodating the growth in money that compensates for the increase in prices. Thus, a rate of credit expansion considered to be non-inflationary should not be far in excess of projected real rate of economic growth plus the desired rate of inflation.

##### **Exchange Rate**

4.4.3 In a small open economy, such as Botswana, which imports a considerable amount of its consumption goods, the rate of inflation would normally and to a larger extent reflect inflation for the imported goods. To the extent that is possible and economically justifiable an exchange rate appreciation could be used to moderate the influence of foreign prices on domestic prices. In the case of Botswana, in recent years especially, the exchange rate is used far less as a nominal anchor for inflation but rather is monitored (and adjusted) to maintain export sector competitiveness.

### **South African inflation**

4.4.4 Botswana gets most of its imported goods from South Africa, hence its inflation would mostly, and to the extent that the exchange rate does not change much, reflect inflation in South Africa. Therefore, the authorities monitor inflation trends in South Africa as well which are taken into account in the monetary policy framework.

### **Fiscal expansion**

4.4.5 Whereas only growth of credit to the private sector is a target of monetary policy and government spending growth is an element of fiscal policy, the latter nevertheless has an influence on monetary policy, in that monetary policy might have to be tightened if inflationary pressures are generated by government growth. The rate of government expenditure growth is thus also monitored to determine its influence on inflation and monetary policy stance as well as advise government on a desired rate that is commensurate with the monetary policy objectives.

## **4.5 Monetary policy operation and instruments**

4.5.1. The Bank Rate and the auctions of Bank of Botswana Certificates are the key tools of monetary policy.

### **Open market operations**

4.5.2 The Bank uses Bank of Botswana Certificates (BoBCs) in open market operations with three main objectives, namely to mop up excess liquidity, achieve positive real rates of interest, and contribute to price stability. The amount of BoBCs auctioned at any particular time is on the basis of funds identified as "excess" and this amount is specified relative to a particular level of real interest rates. The issue of Bank of Botswana Certificates influences liquidity by adjusting the supply (for which the banks bid) and in the process to determine a discount rate which translates into a market interest rate. The Bank of Botswana is, therefore, able to influence the level of liquidity and interest rates in the economy via the market.

### **Bank Rate**

4.5.3 The Bank Rate, which applies to short-term (overnight) financing of commercial bank liquidity needs, is used to signal the desired level and direction of interest rates. Thus its use is in line with the textbook prescription of a reduction in the rate to indicate a loosening of monetary policy and, vice versa, an increase to indicate that economic conditions require an increase in general interest rates. Nevertheless the Bank Rate has been adjusted in order to keep real interest rates in Botswana in line with those of major industrialised countries. The reference, in this respect, is the real money market rate in Botswana, as measured by the real effective yield on the three-month Bank of Botswana Certificates and is compared to real yields in OECD countries.

### **Reserve requirements**

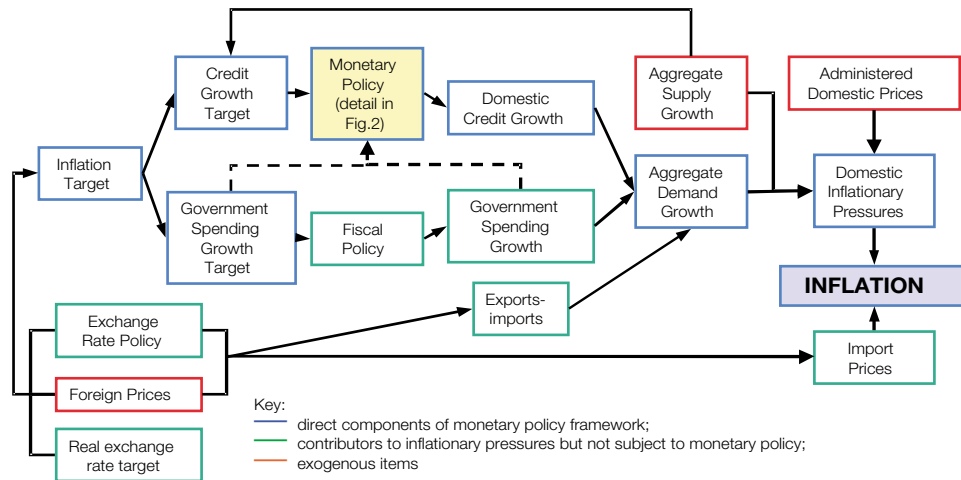
4.5.4 Reserve requirements, which could be considered an alternative to or a means of enhancing the efficacy of Open Market Operations, have been used sparingly in Botswana in consideration of the fact that they tend to put banks at a disadvantage vis-à-vis other institutions that provide similar services. Also given excess liquidity the reserve requirements are unlikely to have much impact.

### **Exchange rate management**

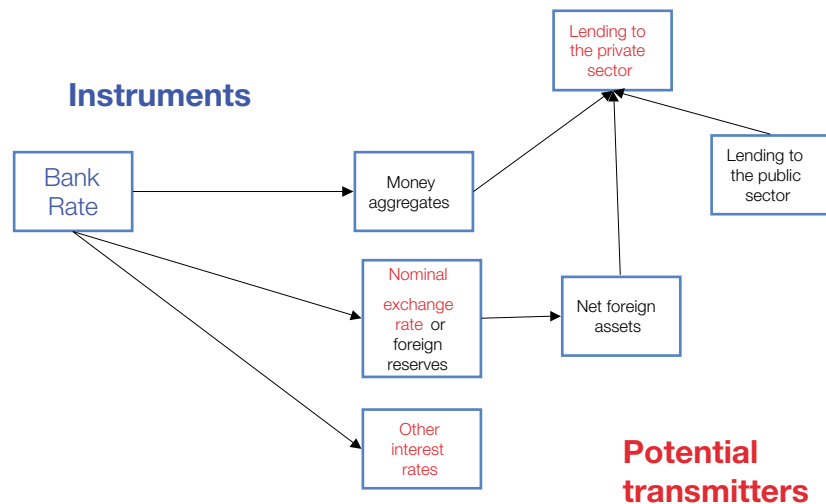
4.5.5 In the current monetary policy framework, and with the focus on economic diversification and export competitiveness, there is less explicit reference and use of the exchange rate as a nominal anchor for inflation. Rather the exchange rate arrangements are biased towards promoting exports.



**Figure 1: Botswana's Monetary Policy Framework**



**Figure 2: Monetary Instruments & Transmitters**



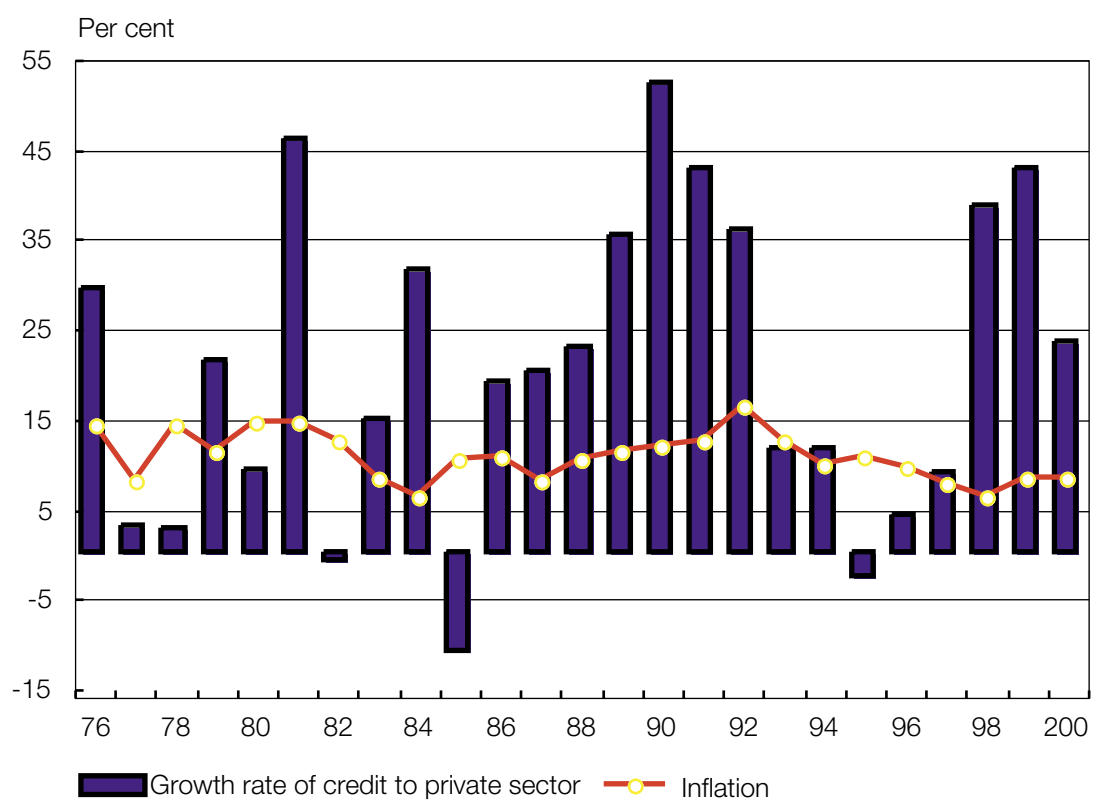
## 5. Policy track record (achievements<sup>8</sup>)

5.1 Movements in the Bank Rate, the target real interest rate and rates of growth of the money supply and credit to the private sector are shown in Charts 5.1, 5.2 and 5.3. Chart 5.1 highlights the substantial increase in the growth rate of credit to the private sector from 1988, which peaked at 52 per cent in 1990. In turn, inflation subsequently increased markedly, and peaked at 17,7 per cent in June 1992. This increase in inflation would seem to have been partly due to excess demand in the economy and partly due to the increase in prices of imported goods (Wright and Kahuti, 1997). Notwithstanding the sources of inflation, it would seem that fiscal and monetary policy were not tightened sufficiently at the time to offset imported inflation (Bank of Botswana, 1993: 18).

<sup>8</sup> This section was extracted from the paper by K S Masalila titled **Financial Liberalisation and Monetary Policy Effectiveness: A Comparison of Botswana, Malawi and Zimbabwe**, in Bank of Botswana Research Bulletin, Volume 19, No. 1.

Chart 5.1

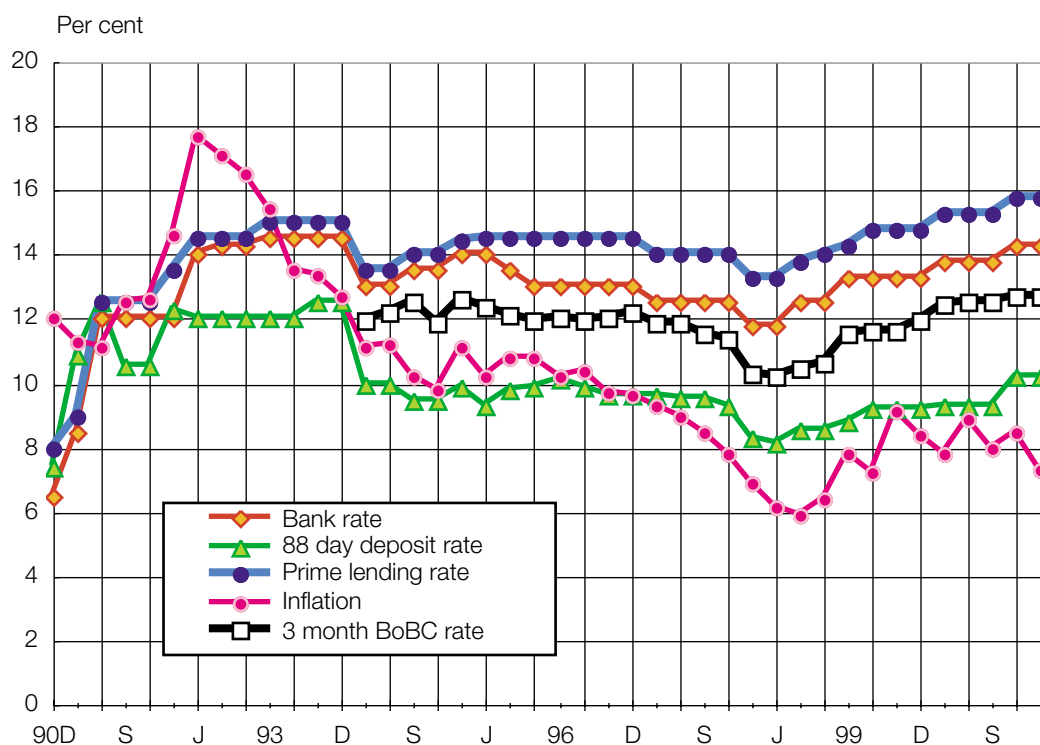
Botswana: Growth in Credit to the Private Sector and Inflation, 1976 - 2000



Source: International Financial Statistics (IMF); Bank of Botswana

Chart 5.2

Botswana: Interest Rates and Inflation, 1990 - 2001

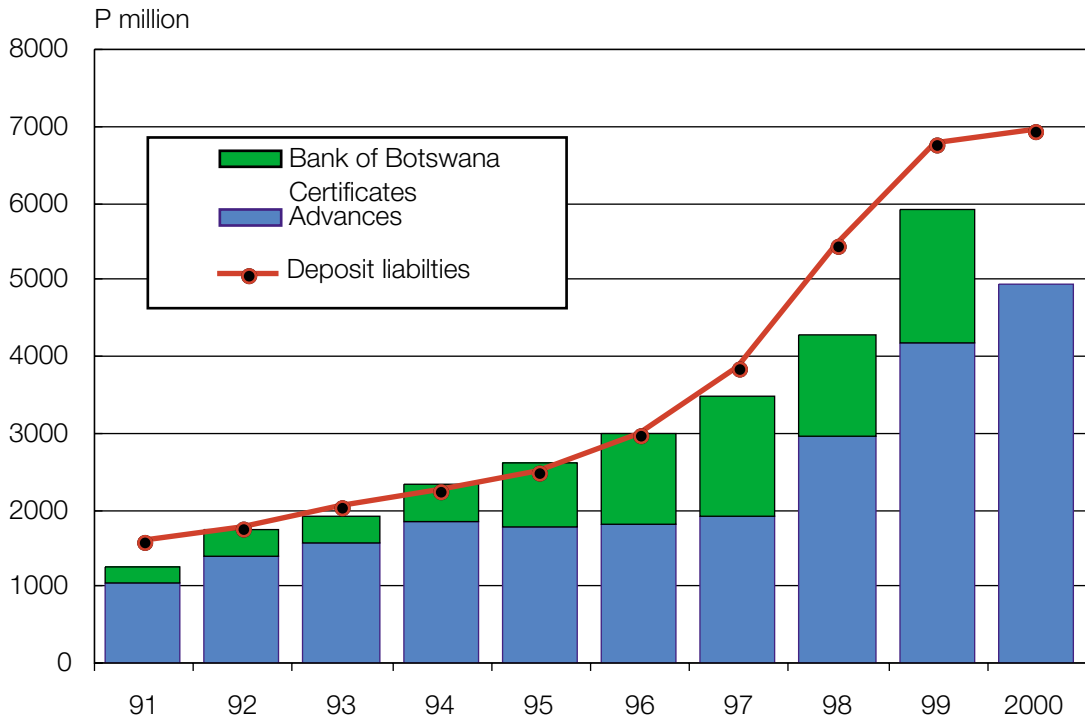


Source: Bank of Botswana

5.2 From the second half of 1992, inflation has generally decreased to reach the lowest level of 5,9 per cent in three months during the second half of 1998. This decrease followed the decline in the rate of growth of credit to the private sector to moderate levels up to 1997. Given the significant reduction in inflation, real deposit rates became less negative and, from the end of 1996, have been positive. These developments were largely the result of action on the part of the authorities, especially involving adjustments to the Bank Rate and mopping up excess liquidity through the sale of Bank of Botswana Certificates. It is notable, though, that subsequently inflation was higher in 1999 and in the first six months of 2000 compared with 1998. Among the factors responsible for this are the substantial rise in the rate of growth of credit to the private sector; the significant injection of liquidity in the economy following the July 1998 adjustment in public sector salaries; and more recently the sustained increase in oil prices. It is also significant that despite the inflationary pressures there was, save for the Bank Rate adjustments in February and March 1999, no major change in the monetary policy stance. For example, the Bank Rate has remained at the same level of 13,25 per cent since March 1999 until February 2000 when it was raised to 13,75 per cent and subsequently to 14,25 per cent in October 2000. The yield on BoBCs on the other hand rose by a higher margin, about 110 basis points, between March 1999 and October 2000, while the liquidity mopping exercise was, compared to the previous years, less comprehensive.

**Chart 5.3**

Botswana: Selected Assets and Liabilities of Commercial Banks, 1991 - 2000

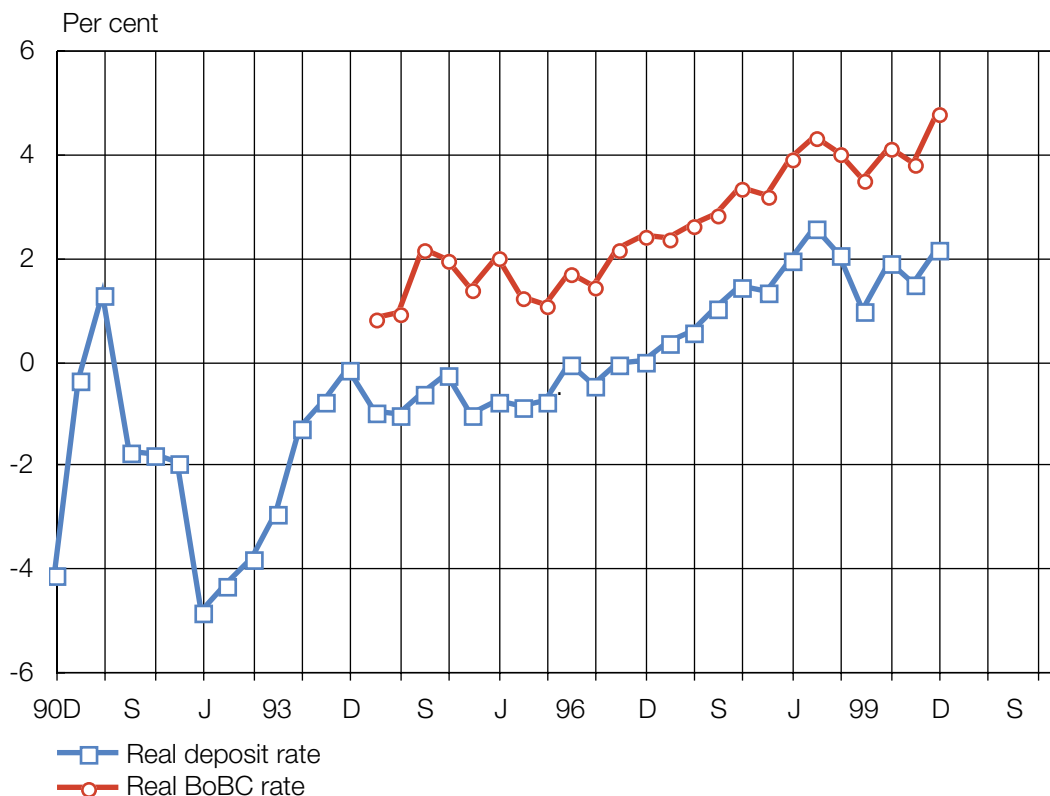


Source: Bank of Botswana

5.3 Chart 5.2 shows adjustments to the Bank Rate which triggered changes in the other interest rates. Progress in reducing excess liquidity is apparent from Chart 5.3. Nominally, excess liquidity, in this instance, is represented by the difference between deposit liabilities and advances (ignoring the required liquid assets). The extent of the absorption of excess liquidity is represented by the volume of the Bank of Botswana Certificates. Overall, despite the rise in inflation in 1999, there is evidence that over time the operation of the policy variables has resulted in a restrained rate of credit growth, lower inflation and positive real rates of interest. Notably, the tight monetary policy stance adopted in 2000 is beginning to show results.

**Chart 5.4**

**Botswana: Real Rates of Interest**



Source: Bank of Botswana

5.4 In the light of the stated objectives, the policy achievements are also reviewed in terms of a comparison of real interest rates in Botswana (i.e., the rate for the three-month Bank of Botswana Certificates) with real rates obtainable (for similar maturities) in major international markets. Initially, the authorities were partially successful in maintaining positive real rates of interest since the introduction of Bank of Botswana Certificates in 1991 (Bank of Botswana 1993). For example, deposit rates, as evident from Chart 5.4, remained negative until the end of 1996, although when using the measure employed by the Bank of Botswana (i.e. a real rate calculated using the three-month annualised rate of inflation), real interest rates have been achieved from the beginning of 1994, albeit with several periods (months) during which negative real rates were recorded. Thus, according to the Bank of Botswana (1993 - 1999), the authorities have broadly managed to achieve this target from 1993 onwards. Since then, the real effective yield on BoBCs has compared favourably with rates prevailing in the major international markets. For example, as indicated in Bank of Botswana (2000), the three-month money market real rate, which was in the 3,3 – 4,4 per cent range in 1999 has compared favourably with an average of 2,62 per cent in the USA and 3,32 per cent in the UK.

5.5 In 2000 the three-month real money market rate ranged between 1,7 and 4,3 per cent compared to an average of 1,3 per cent for both South Africa and the USA, and 2,8 per cent for the UK.

**6. Conclusion**

6.1 Following a period of direct controls on interest rates, the current monetary policy framework encompasses the use of open market operations and the Bank Rate to influence liquidity conditions as well as generate or signal the desired level and direction of interest rates. A review of the impact of policy changes and their operation shows that there has been an active use of indirect

monetary policy instruments in an attempt to achieve the desired objectives. Among the important factors in achieving monetary control is the mopping up of excess liquidity and, to the extent that this has been effectively done, there has been a sustained reduction in inflation. Generally, the monetary authorities have been able to achieve the intermediate targets and a reduction in inflation through using the new policy.

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